INTERNATIONAL MONETARY FUND

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INDIA

2013 ARTICLE IV CONSULTATION

February 2013

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2013 Article IV consultation with India, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 9, 2012, with the officials of India on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 21, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex** prepared by the IMF.
- **Debt Sustainability Analysis** prepared by the staffs of the IMF.
- **Staff Statement** of January 25, 2013.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its January 25, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for India.

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INDIA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

December 21, 2012

KEY ISSUES

Outlook and Risks: The economy has slowed markedly due to a confluence of structural, external and other factors. Recent measures taken by the authorities have boosted confidence, but the near-term outlook is for a subdued recovery with still-elevated inflation as investment has been significantly hit and supply bottlenecks will ease only slowly. Risks are on the downside, but stronger structural reform could lead to better outcomes.

Structural Reform: Building on recent progress is crucial, especially to address supply constraints in energy and move the pricing of various natural resources toward a market basis. Progress on taxation, land acquisition, and labor market reform, along with 12th Plan goals on infrastructure, skills mismatches, and social outcomes, are necessary to return to a rapid rate of growth and poverty reduction.

Demand-Management Policies: The Finance Minister's renewed commitment to fiscal consolidation is welcome, as is the plan to switch to cash transfers, which should improve expenditure efficiency over the medium term. Sustainable fiscal consolidation and reorientation of spending toward investment and social sectors, however, will require tough choices on subsidy reform and an overhaul of taxation. Maintaining policy interest rates unchanged until inflation is clearly on a downward trend is the best way for monetary policy to support growth. The floating rupee and continued prudent liberalization of the capital account will improve resilience to external shocks.

Financial Reforms: Tightening mechanisms to address deteriorating asset quality will promote healthier banks' balance sheets, but supporting faster growth and reaching Basel III targets will also require capital injections in public banks. In addition, addressing concentration risks, strengthening creditor rights, and supporting capital market development will lay the groundwork for a stronger recovery.

Approved By
Masahiko Takeda and Tamim Bayoumi

The Article IV Consultation Discussions were held October 25–November 9, 2012 in Bangalore, Mumbai, and New Delhi. Staff team: L. Papi (head), J. P. Walsh, R. Anand and T. Richardson (SRR) (all APD), P. Lindner (MCM), and D. Coady (FAD, Delhi only).

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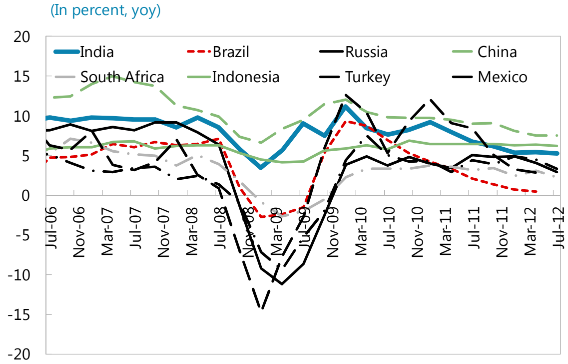
CONTEXT

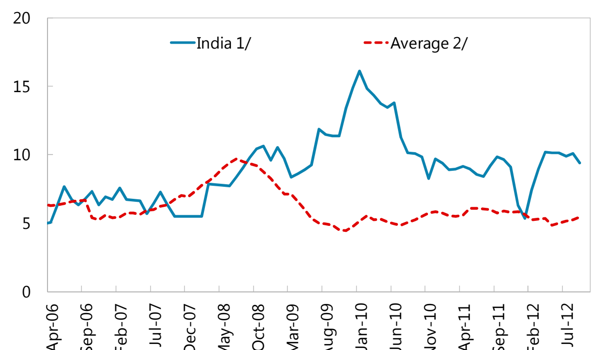
1. After growing strongly before and after the Global Financial Crisis (GFC), India's economy has slowed substantially. Growth averaging 8½ percent and expanding social programs lowered the poverty rate by 1.5 percentage points per year in 2004–09, double the rate of the preceding decade, as shown by the latest quinquennial household survey. Growth returned to this level for two years after the GFC, but decelerated throughout 2011, slumping to only 5.4 percent in the first three quarters of 2012.[1] Though India's growth remains among the highest in the world, the recent slowdown—due to structural factors such as supply constraints and an unsupportive policy environment, with cyclical and global factors also contributing—is unusual among emerging markets (EMs) for its still-high inflation. Nevertheless, the 12th Five Year Plan, expected to be published by end-2012, will likely continue to aspire to growth above 8 percent and to significant improvements in social indicators.

GDP Growth
(In percent, yoy)



Sources: Haver Analytics and staff calculations

Inflation
(In percent year on year)



Sources: Haver Analytics and staff calculations
1/CPI Industrial Workers
2/ Brazil, Russia, China, South Africa, Indonesia, Turkey, Mexico

2. The economy is in a weaker position than before the GFC, with strictly circumscribed policy space and greater domestic and external vulnerabilities. Inflation and the fiscal deficit remain among the highest in EMs. At the same time, the financial positions of banks and corporates, both strong before 2009, have deteriorated. The current account deficit (CAD) widened to 4.2 percent of GDP in 2011/12 and other external vulnerability indicators have deteriorated, which led to a sharp depreciation of the rupee in 2011 and early 2012.

3. The authorities are keenly aware of the situation and have moved in recent months to reverse the slowdown and lower vulnerabilities. Measures taken include higher diesel prices and quantity limits on subsidized LPG, two challenging but essential measures to rein in the fiscal deficit. The government announced further liberalization of FDI and a plan to restructure the debts and reduce the losses of state power distribution companies (discoms), and has just announced a Cabinet

[1] The discrepancy between the growth rates derived from the supply side and expenditure side has increased in recent quarters, complicating the assessment of the economy. Supply side data, which are used in this report, are deemed to be more reliable.

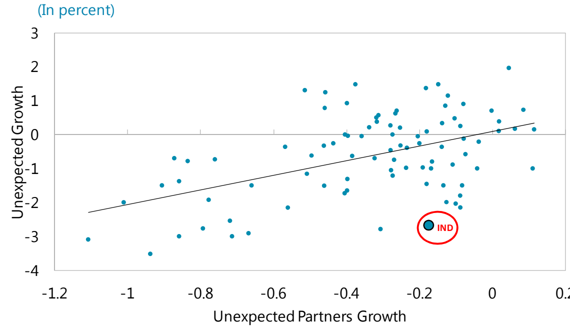
Committee on Investment (CCI), enabling single-window approval for large projects. The new Finance Minister (FM) is strongly committed to a medium-term deficit reduction plan. These and other measures have achieved a remarkable turnaround in market sentiment, but all eyes are on the government to deliver on its commitments before the national elections due by May 2014.

RECENT DEVELOPMENTS

A. Growth Slowdown

4. GDP growth has slowed more than external factors can explain. Falling infrastructure and corporate investment led the slowdown, though exports and private consumption are now also suffering (Figure 1). Global factors have hurt exports and weighed on investment, but India's growth has slowed by more than the decline in trading partners' growth would imply. Capital inflows remain resilient and international financing conditions favorable, suggesting that so far the financial channel has not been prominent in the transmission of external shocks (Figure 2).

The 2012 Slowdown: More than External Spillover
(In percent)



Sources: IMF, World Economic Outlook; and IMF staff calculations.
Note: Unexpected growth denotes real GDP growth in 2012 (Sept 2012 WEO) minus the forecast (Sept 2011 WEO). Partners growth is export weighted average.

5. Fiscal and monetary policies have neither aggravated nor significantly alleviated the slowdown. The slow consolidation following the large crisis-period stimulus means that fiscal policy has not tightened, and this year's impulse will be around ½ percent of GDP (Figure 3). After remaining mostly negative since the GFC, the tightening of monetary policy in 2010–11 has increased short-term real interest rates to levels similar to those seen before the GFC (Figure 4). But with the Reserve Bank of India's (RBI) 50 basis point (bp) cut in April 2012, a cash reserve ratio (CRR) now 150 bp lower than at end-2011, and the depreciation of the rupee, monetary conditions have eased.

6. Market sentiment has improved, but elevated inflation and twin deficits weigh on investor confidence. Financial markets rallied following the government's recent measures, but market participants are looking for progress on implementation and additional policy actions to sustain momentum. Also, concerns remain about inflation persistently above the RBI's objectives, repeated fiscal slippages, the widening CAD, and a possible credit rating downgrade.[2]

7. Several causes of the weaker growth seem to be of a supply-side nature.

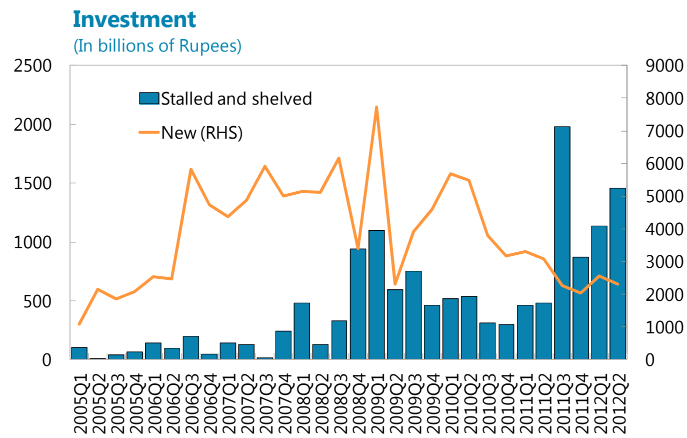
[2] India has a BBB- sovereign credit rating. Moody's has recently reaffirmed a stable outlook, while S&P and Fitch have a negative outlook.

- *Rising policy uncertainty*. In particular, high profile tax policy decisions announced in the 2012/13 Budget have reduced foreign investors' interest in India, while the increasing difficulty of obtaining land use and environmental permits have raised regulatory uncertainty for infrastructure and other large-scale projects.[3]

- *Delayed project approvals and implementation*. As a reaction to recent high-profile governance scandals, project approvals, clearances, and implementation have slowed sharply.

- *Supply bottlenecks* are particularly pronounced in mining and power, with attendant consequences for the broader economy, especially manufacturing (Box 1).

8. With investment particularly hard-hit, potential GDP is likely to be lower than previously estimated. High frequency indicators have stabilized, but new investment project announcements are sharply down and more projects are being stalled or shelved. Increasingly, analysts and policymakers are marking down India's growth potential. IMF estimates are in the 6–7 percent range, from 7.5 to 8 percent in recent years' consultations (Box 2). Further, elevated inflation points to still-binding supply constraints.



Source: CMIE.

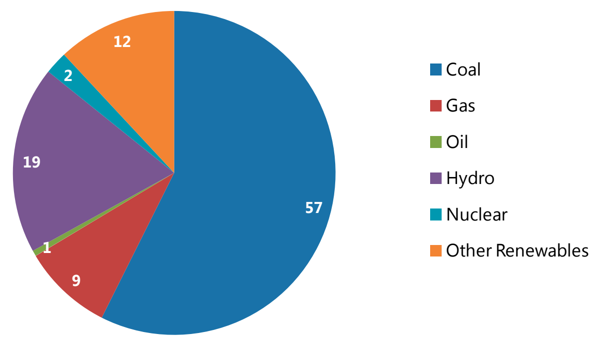
9. The domestic implications of India's slower growth could be far-reaching, though potential international spillovers are likely limited. Scant data on employment notwithstanding, lower medium-term growth might not generate sufficient jobs to absorb labor market entrants. Weaker growth also entails a slower reduction in poverty. IMF research suggests that 35 million more people would remain below the $1.25/day line compared to a scenario in which growth returns to the 2004–09 average (Box 3). On the other hand, India's imports account for 2.6 percent of global imports, so direct spillovers to other countries are likely to be contained. Estimates from a three-region Global Integrated Monetary and Fiscal (GIMF) model suggest a 2.5 percentage point growth slowdown in India (equal to this year's projected growth compared to the 8 percent average of 2007–11) is likely to have a 0.05 percent impact on Euro area growth and 0.03 on the growth of the rest of the world. The impact, however, is likely to be larger for some low-income countries and the South Asian economies, especially Nepal. Staff estimate that growth in South Asian economies could decline by about

[3] Observers interpreted these tax measures as bringing certain activities into the tax net that were previously considered offshore, with some retroactive elements. These measures are currently being reassessed.

Box 1. India's Energy Sector

India has a substantial electricity deficit. Electricity demand growth has outstripped growth in energy generation.[1] Along with underinvestment in transmission and distribution, this has led to frequent blackouts, and occasional large blackouts such as the near-nationwide event of July 2012. Investment in generation capacity has risen by about half since 2006/07, but some of the new plants have not been commissioned, as securing coal supplies has become increasingly difficult and their customers, local power utilities (discoms), cannot afford market rates for power. As a result, power deficits have continued to rise and are estimated at about 8–9 percent.

Installed Electricity Generation Capacity by Source, 2012
(In Percent)



Source: Indian Ministry of Power

Difficulties in getting coal to power plants have magnified these challenges. Coal accounts for nearly 60 percent of India's electricity production. Slow development of new coalfields by Coal India Limited (CIL), the monopoly coal producer, along with regulatory delays (mainly environmental clearances) have resulted in a widening gap between coal production and demand. Despite having the world's fifth-largest coal reserves, India imports around one-fourth of its coal. Some coal fields are also allocated to specific power plants, but even in these cases, supplies are often underutilized. In addition, domestic coal prices are fixed by CIL well below international prices, reducing the profits of generation plants planned on domestic coal, but which now depend on imports, whose prices have risen to pre-crisis highs.

Electricity distributors are generally loss-making. Discoms, almost all of which are publicly owned, buy electricity from producers at market prices. But discoms' tariffs, which need to be approved by state regulatory bodies, are for the most part below cost-recovery levels even after this year's tariff increases, leading to large and long-standing losses. Discoms' losses also result from high transmission losses and other inefficiencies.

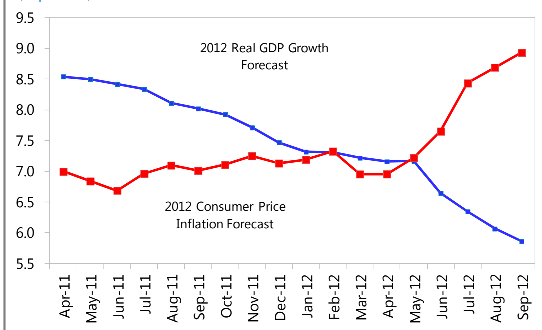
These distortions have had knock-on effects on the economy. The slowdown in energy and coal projects has been a key cause of weak infrastructure and corporate investment. Resulting electricity shortages have lowered production and added to companies' costs. Delayed or shelved power projects and discoms' difficulties—though restructuring of their debts has now begun—have contributed to deteriorating asset quality at banks.

[1] See World Bank "*India Economic Update*," September 2012 for a detailed analysis.

Box 2. Potential Growth

Slowing growth coupled with elevated inflation has raised questions about India's growth story. Consensus Forecast growth projections for this year and next have been lowered substantially, while inflation projections have been raised**.** Even though some have attributed this slowdown to global conditions and demand-side factors, increasingly, analysts, observers, and policymakers are questioning India's potential growth. Only a year ago, estimates of India's potential growth were in the 8–9 percent range, with some forecasting India overtaking China. JP Morgan has put potential growth at 6–6.5 percent and other analysts have also suggested a decline. The RBI, acknowledging the impact of structural factors, has lowered its estimate of potential growth to 7 percent from its earlier 8 percent, and the Prime Minister Economic Advisory Council estimates a fall of over 1 percentage point in potential growth. However, the forthcoming 12th Plan is likely to aim at 8 percent growth.

India Consensus GDP Growth and Inflation Forecasts
(In percent)



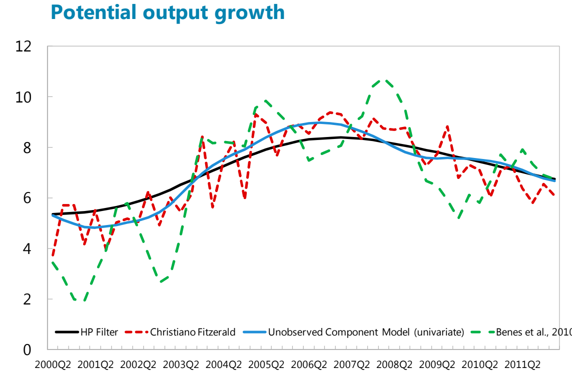
Source: Consensus Economics Inc.

Table. India: Summary of Potential Ouput Estimates	2012 Q2
Potential Output Growth (average of estimates)	**6.6**
HP filter	6.8
Baxter King band pass filter	6.4
Christiano Fitzgerald asymmetric band pass filter	6.2
Univariate Unobserved Component Model	6.7
Multivariate Unobserved Component Model	6.6
Model based (Benes et al. 2010)	6.7

Source: IMF staff estimates

Staff estimates across a range of methods suggest that potential growth has declined to about 6½ percent. The highest estimate at 6.8 percent is obtained with the HP filter, while the lowest at 6.2 percent is estimated with the Christiano-Fitzgerald filter.[1]

Potential output growth



Sources: WEO and staff estimates

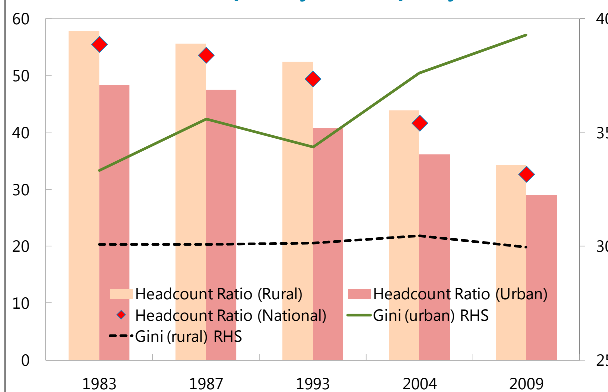
Even though statistical estimates of potential growth have limitations, there is growing evidence that the current slowdown has an important structural component. Inflation continues to be elevated. Surveys indicate that despite declining growth, delivery times have not improved and work backlogs have risen. Also, binding supply constraints are translating into higher imports (coal is the most obvious example). As the decline in investment trend growth affects potential growth with a lag of around eight quarters, unless investment revives soon, GDP growth over the next five years is likely to be affected. Also, the sharp decline in infrastructure investment is likely to lower productivity growth in many sectors, keeping potential growth relatively subdued.

[1] Staff did not estimate the potential growth using the production function approach due to the lack of reliable employment data.

Box 3. The Evolution and Outlook for Poverty[1]

High growth during 2004–09 accelerated poverty reduction. Compared to the previous decade, the rate of poverty reduction doubled, with the share of the population living below the poverty line falling from 41½ percent in 2003/04 to 32½ percent in 2009/10—more than during the previous decade.[2] As shown by the most recent quinquennial household survey by the National Sample Survey Office (NSSO), poverty declined sharply in both rural and urban areas. Although the average annual rate of poverty reduction was ½ percentage point higher in rural areas, the gap between the rural and urban areas widened with the ratio of rural to urban average per capita consumption declining from 0.53 in 2004/05 to 0.49 in 2009/10. Also rural inequality declined marginally, but urban inequality increased.

The evolution of poverty and inequality in India



Sources: Povcalnet, NSSO 66th Round and staff calculations.

Table 2. Impact of Food Price Increases on Poverty

	Current Poverty Rate	Food Price Increase Scenarios: 5%	10%	15%
Poverty Headcount: Population Below the Poverty Threshold				
(In percent of total population)				
1.25$ per day	32.7	35.2	37.8	40.7
National poverty line	29.8	32.3	35.0	37.7
Decline in Purchasing Power of the Poorest Household				
(In percent)				
1.25$ per day		3.2	6.6	10.0
National poverty line		3.2	6.6	10.0

Source: IMF staff estimates.

Table 1. India: Growth and Poverty Reduction

% per year	1993-2004	2004-2009	1993-2009
GDP per capita	4.90	6.51	5.09
Headcount index ($1.25)	-1.69	-4.74	-2.55
National povery line	-1.95	-4.34	-2.58
Elasticity of poverty reduction to GDP growth			
Headcount index ($1.25)	-0.35	-0.73	-0.50
National poverty line	-0.40	-0.67	-0.51

Source: IMF staff estimates

The current slowdown in growth, if protracted, would severely hamper poverty reduction. Using the long-term estimate of the growth elasticity of poverty reduction (proportional change in poverty per unit growth in GDP per capita) of 0.5, which is lower than other EMs, the current subdued economic outlook implies a 30 percent lower reduction in the poverty headcount ratio by 2015 compared to a scenario in which growth remains at the 2004–09 average.

High food price inflation can also jeopardize poverty reduction. A 10 percent increase in relative food prices would put more than 50 million below the poverty line. As poor households spend more on food, their purchasing power would be eroded more. In the case of a 10 percent increase in relative food prices, the purchasing power of the poorest households would decline by over 6 percent.

[1] Based on a forthcoming IMF working paper by Rahul Anand, Naresh Kumar, and Volodymyr Tulin.

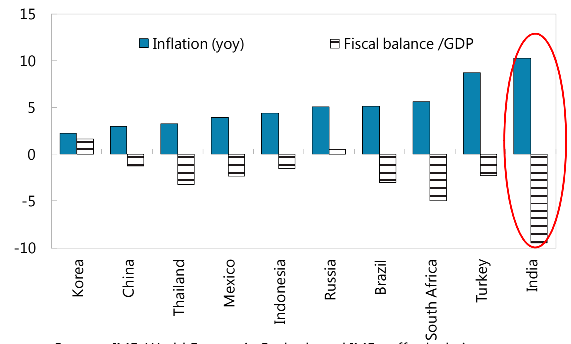
[2] The poverty line used here refers to $1.25 a day, while the national poverty line refers to the poverty line computed using Tendulkar committee methodology, according to which poverty was 29.8 percent in 2009/10.

1 percentage point in response to a decline of 2.5 percentage point in India.[4] Though trade and financial flows between South Asia and India are relatively small, these growth estimates suggest that other linkages, for example sharing of human capital and confidence effects, are important.

B. Limited Policy Space

10. High deficits and debt limit fiscal policy space. Weak activity has hurt tax receipts, and measures to contain subsidies will only have full-year effects beginning in 2013/14. While the government has begun to rein in expenditure, this year's modified budget target of 5.3 percent under the authorities' definition is still likely to be breached by 0.3 percentage points. The resulting 9.0 percent of GDP general government deficit represents only a slow pace of consolidation from the 2008/09 peak of 10 percent. With high nominal GDP growth, the debt to GDP ratio has fallen from 75 to 67 percent in recent years, but a shock to growth or continued high deficits would cause the burden to rise. In addition, public bank recapitalization and the assumption of discoms' debts will add to public debt. The Statutory Liquidity Ratio (SLR) requires banks to hold at least 23 percent of their liabilities in the form of government securities, moderating interest rates, but a rise in the deficit could crowd out private investment.

Inflation and Fiscal Balance, 2012
(In percent)



Sources: IMF, World Economic Outlook; and IMF staff calculations.

11. Entrenched inflation is constraining the room for monetary policy easing. Despite some moderation, WPI inflation is still at 7.25 percent and CPI inflation at 9.9 percent.[5] After easing in early 2012, momentum, including for core, remains strong. Wage growth is still reported in double digits, and household inflation expectations have softened, but are still at 11–12 percent. The effects of the recent fuel and energy price increases and rupee depreciation have not yet been fully felt. High inertia is likely to keep inflationary pressures strong until the output gap widens sufficiently to ease them.

C. Weaker Financial Positions of Corporates and Banks

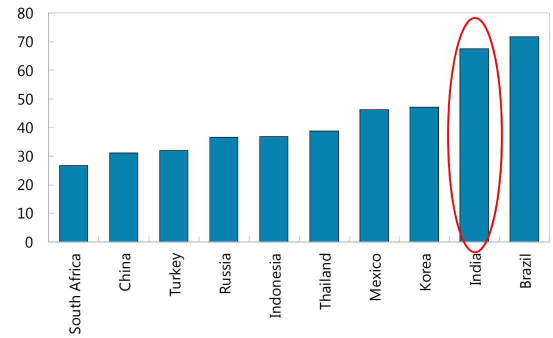
12. Corporate financial positions have weakened considerably, further dimming the outlook for investment and heightening vulnerabilities. Profitability, which had recovered after the GFC, has weakened mainly due to weaker internal and export demand, bottlenecks, slow

[4] Ding Ding and Iyabo Masha (2012), "India's Growth Spillovers to South Asia," IMF Working Paper, WP/12/56.

[5] Inflation has been often subject to upward revisions, averaging 0.3 percentage points in the past 6 months.

permits for infrastructure projects, and rising interest rates (Annex I). At 65.5 percent of equity at end-2011, the median debt is above pre-crisis levels and high compared to EM peers. Restructuring of corporate debt has risen significantly and rating agencies expect further increases.

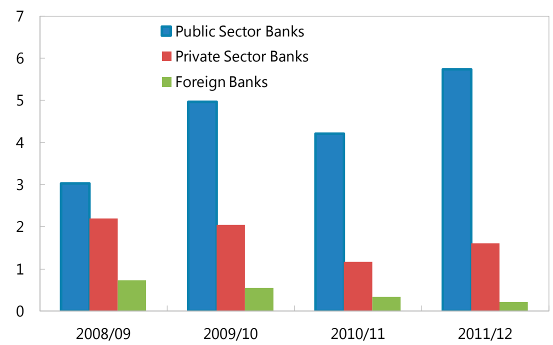
Corporates: Median Debt to Equity
(In percent)



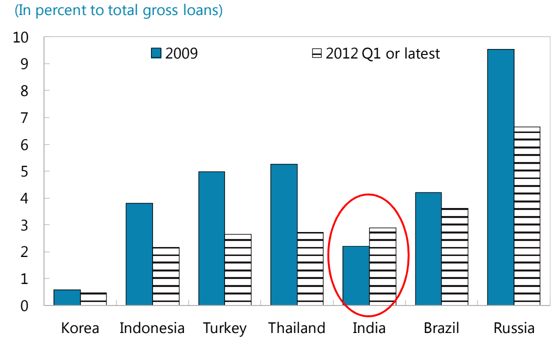
Source: IMF, Corporate Vulnerability Utility.

13. Banks' capital ratios have fallen slightly, but asset quality is deteriorating considerably. System CAR was at 13.7 percent in June 2012, while gross nonperforming assets (NPAs) have increased by 44 percent year-on-year to 3.2 percent of total advances (Figure 5). Restructured loans, which under Indian regulation are not counted toward NPAs, rose to 5.4 percent of loans in June 2012 from 3.7 percent in March 2011. The position is worse among public banks, where lending is particularly focused on weak areas, such as infrastructure (especially the power sector), aviation, agriculture, steel, and textiles. Reflecting lower provision coverage, public banks' net NPAs were at 1.75 percent in June 2012 compared to about 0.5 percent for private banks. In addition, banking sector loans to 10 of India's largest conglomerates have been reported to account for almost 100 percent of banks' net worth. These groups, many of which are highly leveraged, are in turn also exposed to the vulnerable power and infrastructure sectors. Weaker credit quality has contributed to decelerating nonfood credit growth and prompted the RBI in October 2012 to require banks to increase provisioning for restructured advances as recommended by the Mahapatra Working Group (WG) and to improve information sharing on credit, derivatives, and unhedged foreign exchange (FX) exposures.[6]

Outstanding Restructured Advances
(In percent of gross advances)



Non Performing Loans
(In percent to total gross loans)



Sources: IMF, Financial Soundness Indicators; Country authorities; and CEIC Data Company.

14. Bank capital needs will increase for Basel III implementation, and rising NPAs could push them higher. India is among the first G20 countries to have developed Basel III-compliant regulations. The government has injected capital into its banks, but the RBI projects that full

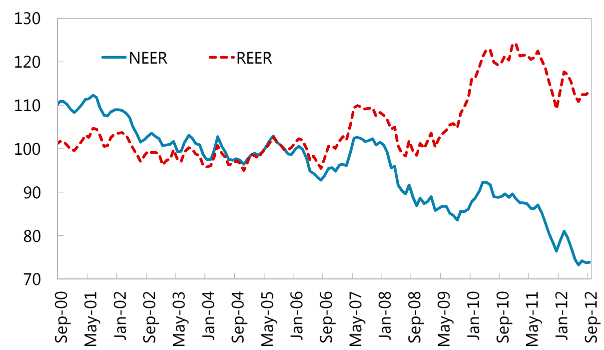
[6] The RBI Mahapatra WG on restructuring of advances recommended that over the next two years the RBI do away with the regulatory forbearance regarding asset classification, provisioning and capital adequacy on restructured assets; increase provisioning to 5 percent from the new 2.75 percent; increase the borrower's contribution upon restructuring; and tighten viability parameters.

implementation of Basel III by 2018, without dilution of government ownership and assuming 20 percent growth in risk weighted assets, could necessitate government capital injections of about 1 percent of GDP.[7] In addition, the October 2012 GFSR noted that India, together with other EMs, is in the late stages of the credit cycle, suggesting NPAs and debt restructurings are likely to continue rising. And with growth likely to be weaker for a longer period than after 2008/09 and the loan composition of banks more skewed toward large loans, more restructured advances are likely to slip into NPAs compared to the historical average of 15 percent.

D. Rising External Vulnerability

15. The current account deficit registered a record high of 4.2 percent of GDP in 2011/12. After a period of strong performance, exports decelerated sharply from late 2011, while imports have slowed only moderately. Gold imports, used partly as an inflation hedge, rose by 60 percent. Binding supply constraints have encouraged imports, but constrained exports. As a result, despite RBI intervention, the NEER depreciated by 9 percent in 2011/12, partly reversing a 21 percent real appreciation over the previous two years. The Pilot External Sector Report and the updated external balance assessment suggest that India's current account and the value of the rupee are broadly consistent with medium-term fundamentals (Box 4).

Effective Exchange Rates
(Index, 2005=100)



Source: IMF, Information Notice System.

16. The widening of the current account deficit has increased market concerns over external vulnerabilities. A current account deficit of 3–3.5 percent of GDP is broadly consistent with India's relatively high growth and low capital-to-worker ratio. In the medium term, as supply-side constraints are eased and external demand recovers, the highly diversified and fairly sophisticated nature of Indian exports should lower the CAD, while the flexible exchange rate should continue to offset inflation differentials. In the near term, however, the widening of the CAD at a time when growth and investment are weakening has increased market concerns about external vulnerabilities and led to pressures on the exchange rate. These concerns are partly related to the steady increase in recent years in debt liabilities in the overall international investment position (IIP).

17. Capital flows are shifting toward debt and reserve coverage is falling, but currently overall external vulnerability remains manageable. Before the GFC, inward FDI more than financed the CAD, but in 2011/12 covered only half (Figure 6). Debt flows, particularly short-term and in the form of non-resident Indian (NRI) deposits, have partly compensated, but rising corporate foreign borrowing, reportedly mostly unhedged, is a concern. The net IIP has deteriorated. While both assets and liabilities have risen, external debt has increased by 53 percent in the past three years and is

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7 Capital needs among private banks are small.

concentrated among corporates, even if external debt at 20 percent of GDP remains moderate compared to other EMs. Reserves coverage has fallen to 1.6 of the gross financing requirement from 4.3 in 2007 and 6 months of imports from 12 months in 2007, but the IMF composite reserve measure suggests that India's reserves remain adequate, taking into account the forward position and other country-specific circumstances.

Box 4. External Balance Assessment

The External Balance Assessment (EBA) comprises three different methods for assessing the appropriate current account and exchange rate compared to medium-term fundamentals and appropriate policies.[1]

Table. External Balance Assessment Results

	EBA Methodologies		
	CA Regression	REER Regression	External Sustainability
CA Norm (% GDP)	-3.4		-2.3
CA Gap (% GDP)	0.7		-0.5
Exchange rate gap 1/	-(3.5 - 4.5)	12	3

1/ Positive values indicate overvaluation.

- The EBA current account regression estimates India's cyclically-adjusted current account norm, i.e., the current account compatible with fundamentals and desired policies, to be -3.4 percent of GDP. The projected 2012 CAD of 4 percent of GDP corresponds to a cyclically adjusted CAD of 2.7 percent of GDP, implying a current account gap of 0.7 percent of GDP. The cyclically adjusted CAD is much lower than the actual as the output gap is small relative to the rest of the world's output gap and the terms-of-trade gap is large. These results suggest that the real exchange rate is undervalued by 3.5–4.5 percent if the current account gap is to be closed only through real effective exchange rate (REER) adjustment.

- The second method based on a REER regression derives the deviation of the REER from its estimated equilibrium level, based on a set of fundamentals. This suggests that India's REER is overvalued by around 12 percent.

- The third method is the External Sustainability approach, which computes the current account balance that stabilizes the net foreign asset (NFA) position. According to this approach, India's current account norm is -2.3 percent of GDP, which is slightly lower compared to staff's CAD projection for 2017 (the outer year of the medium-term horizon when output gaps are generally assumed to be closed). This is similar to the RBI's finding that India's sustainably-financed current account deficit is around 2.5 percent of GDP.[2] Using this approach, the real exchange rate is broadly in line with its medium-term equilibrium value.

[1] See the 2012 Pilot External Sector Report (www.imf.org) for a discussion of EBA methodologies.

[2] Rajan Goyal, 2012, "Sustainable Level of India's Current Account Deficit," RBI Working Paper Series.

OUTLOOK AND RISKS

18. **Growth is projected at 5.4 percent this year, but should pick up to 6 percent in 2013/14.** No legislative changes are assumed in the baseline, but continued implementation of measures to facilitate investment and slightly stronger global growth should deliver a modest rebound in the near term and raise medium-term growth to the upper range of potential estimates. WPI inflation is projected at 7.8 percent by March 2013 and 7.2 percent by March 2014, above the RBI's comfort zone of 4–4.5 percent, given that supply constraints will ease only gradually. The CAD should narrow marginally this year to 3.9 percent of GDP, aided by falling gold imports, a weaker rupee, and broadly stable oil prices. Though the market share of Indian exports has declined in recent quarters, with reduced domestic constraints, India's well-diversified and sophisticated exports are expected to pick up and reduce the CAD over the medium term.

19. **Global risks are on the downside, while recent government action has mitigated domestic risks (Box 5).** According to the October 2012 *World Economic Outlook,* the probability of global growth falling below 2 percent has risen to one in six. A major global financial shock would present serious funding and liquidity risks for India. A sovereign downgrade would severely complicate the financing of the CAD and debt refinancing. Higher oil prices remain an additional downside risk, though one linked mainly to geopolitical developments. On the domestic front, insufficient follow-through on recent reforms would be highly damaging as confidence has just begun to revive. Failure to ease supply constraints, especially for power, would further weigh down growth. Resorting to expansionary fiscal policy would exacerbate inflation and worsen the CAD. On the upside, going beyond announced reforms or legislative progress, especially a comprehensive subsidy reform, the Goods and Services Tax (GST), or land acquisition, would lead to higher growth than in the baseline.

20. **The weaker macroeconomic environment magnifies the damage that potential negative shocks might cause.** While presently manageable, India's CAD and its rising dependence on debt finance amplify potential damage from a renewed bout of global financial turmoil or insufficient fiscal consolidation. The scope for lower policy rates and especially wider fiscal deficits to cushion the blow of a potential shock is small. Likewise, a boost in public banks' credit, as happened in the aftermath of the GFC, is inadvisable given the outlook for NPAs. If banks' and companies' balance sheets are not strengthened, they can exert downward drag on the recovery over the medium term.

Authorities' Views

21. **While supply-side factors might have had some role, the authorities emphasize the role of cyclical and global factors in the current growth slowdown.** They noted that India's slowdown is not that different from that experienced by other emerging economies. RBI's analytical work suggests that around a third of the slowdown in GDP growth can be accounted for by higher interest rates, though they note that this is a recent phenomenon and agree that supply-side factors, too, have played an important role in the recent investment slump. Also, the authorities believe that long-term productive capacity has been less affected.

Box 5. Risks

India: Risk Assessment Matrix

Nature/Source of Threat	Likelihood	Impact	Policies to Minimize Impact
		Domestic Risks	
Continued investment slowdown	***M-H***	***H*:** Growth will fall further, worsening tax revenues, adding to corporate vulnerabilities and NPAs. Failure to increase the economy's capacity would exacerbate inflation and the current account deficit.	Further measures to ease supply bottlenecks, reduce policy uncertainty, and improve the business climate.
Continued high and volatile inflation	***M***	***M–H*:** High inflation could weaken trust in economic management, depressing investment. It also hurts the poor, especially in urban areas, the most. Rising inflation expectations could complicate bringing inflation down in a sustainable way, further damaging the growth outlook.	Maintaining current monetary policy stance until inflation is clearly on a downward trend. Improved agricultural productivity and investment in infrastructure to improve supply response can reduce food price pressures.
Populist fiscal expansion	***M***	***M*:** The captive investor base for government bonds lowers financing risks. Crowding out could hurt investment, and given little spare capacity, inflation and the current account deficit would rise. Continued slow fiscal consolidation would depress sentiment and increase India's vulnerabilities.	Fiscal consolidation and subsidy reform protecting the poor must be undertaken. Spending reorientation will make consolidation growth-friendly.
Balance sheet risks	***M***	***M–H*:** Continued corporate stress could add to NPAs, raising capital concerns and reducing lending in the medium term.	Strengthened oversight of financial and corporate risks. Policies to incentivize genuine corporate restructuring and improvements to insolvency framework.
		External Risks	
Protracted slow growth in Europe	***M***	***M–H*:** A deterioration in the global outlook would further cloud the prospects for recovery, both for exports and investment.	Structural reform will raise returns to investment and strengthen domestic sources of growth.
Strong intensification of the euro crisis or EM capital flow reversal	***M***	***H*:** As in 2008/09, financial stresses would be severe, given sizable current account deficit and increased balance sheets and external vulnerabilities, and especially if combined with credit rating downgrade.	Reconstitute policy space. Focus capital account liberalization on FDI and rupee debt. Continued interregulatory coordination and monitoring of financial conditions and risks. Rupee flexibility would absorb some of the shock and monetary policy could be eased.
Short-term U.S. fiscal cliff	***L***	***M*:** Heightened uncertainty would further depress investment.	Policies to foster domestic sources of growth, e.g., investment in infrastructure.
World Oil Price Shock (US$160 per barrel)	***L***	***M-H*:** Significant effects on the current account deficit, inflation, and, if subsidies remain unreformed, the fiscal deficit.	Shift toward market pricing to minimize fiscal impact and improved targeting of subsidies to shelter the most vulnerable.

"L"=Low; "M"=Medium; "H"=High.

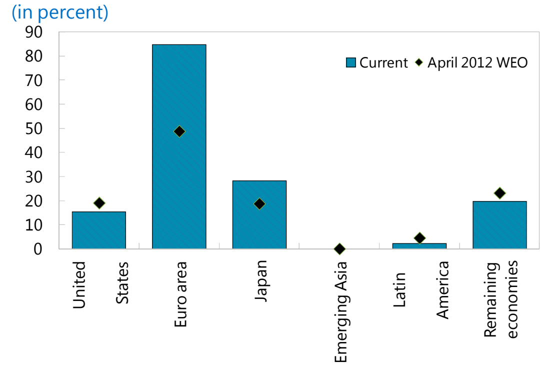
This matrix shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The Risk Assessment Matrix reflects staff views on the source of risks and overall level of concern as of the time of discussions with authorities.

Box 5. Risks (concluded)

Implications for India of Global Risk Scenarios

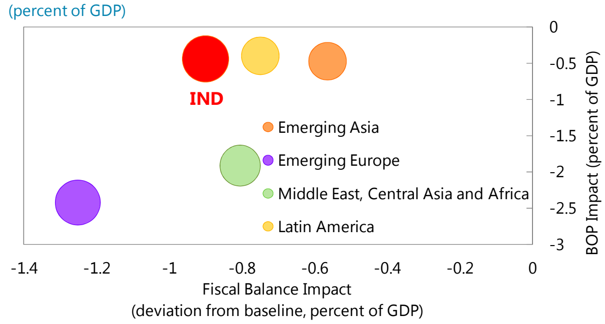
The global environment remains highly unsettled, with significant risks for India. Global growth remains subdued, and risks are weighted toward the downside. Since earlier this year, the probability of recession in the euro area and Japan has risen, while risks have receded only marginally or remain the same in other regions. The IMF's October 2012 *World Economic Outlook* explores possible risk scenarios in detail, including some which might be expected to have significant repercussions for India.

Probability of Recession in Major Markets
(in percent)



A continued or broadened stagnation in global growth would weigh heavily on Indian growth. India's diversified trade patterns would not insulate it from global stagnation. India's growth, though not as export-dependent as that of EMs in other regions, would remain sluggish—staff estimates indicate that for every percentage point of lower global growth, India's growth would be 0.5 percentage point lower. The current account deficit would widen slightly due to growth differentials, while slower growth would weigh heavily on India's large fiscal deficit.

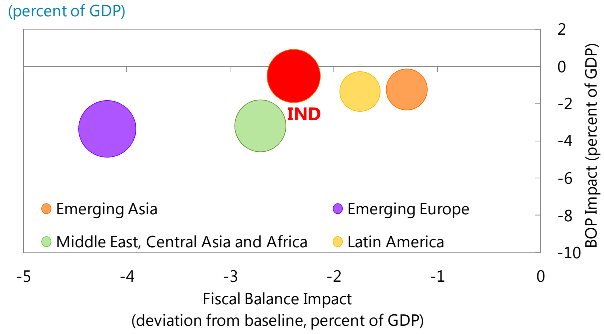
Impact of Growth Stagnation on EM Growth, Fiscal and External Sectors
(percent of GDP)



Source: IMF Staff Calculations
Regional averages are GDP weighted.

Alternatively, a sudden intensification of euro area risks would amplify financial sector risks with a greater growth impact. The impact of a euro area crisis would likely be similar to that of the global financial crisis, but the quick rebound of 2009 is unlikely, given the weaker macroeconomic environment and more constrained policy space. Given India's greater dependence on capital inflows compared to countries in the region, the financial channel would have strong negative effects. The growth effect, mostly through the effect of financing constraints on investment, would be large compared to regional EM peers, weighing on the fiscal deficit, though import compression due to financing constraints would likely bring down the current account deficit.

Impact of Euro Area Shock on EM Growth, Fiscal and External Sectors
(percent of GDP)



Source: IMF Staff Calculations
Regional averages are GDP weighted.

22. The authorities expect a stronger recovery than staff. While the differences for 2012/13 are small, they view staff's 2013/14 forecast as too cautious, pointing to several initiatives that should spur investment and lead to higher growth and lower inflation. They remain concerned about the CAD, due to weak global growth and inelastic demand for oil imports.

23. The balance of risks has shifted away from the domestic economy and toward the globe. With the reform momentum gathering pace, downside risks emanating from India have receded, as has the possibility of a rating downgrade. Continued slow growth in developed economies and the potential for serious disruptions in the U.S. and euro area are deemed the main risks.

POLICY DISCUSSIONS

A. Structural Policies and Supply Bottlenecks

24. Addressing structural challenges in the power sector and in natural resources is key. Almost all discoms have raised tariffs this year, but much more needs to be done to eliminate losses as tariffs remain on average below cost recovery and inefficiencies high. Infrastructure connecting fuel sources with power plants is an urgent problem hampering electricity generation. More broadly, the pricing and allocation of a wide range of natural resources or goods immediately produced from them such as coal, natural gas, electricity, and fertilizers, are subject to complex mechanisms and regulations and are highly inefficient.

25. Ensuring government decisions are expedited and improving governance are important next steps. The new CCI, by facilitating environmental clearances and streamlining approval processes, should help fast-track infrastructure projects. Greater policy predictability and uniform enforcement, and simpler and more transparent administrative procedures are essential to revive investment. The FM's commitment to clarify tax provisions that added to policy uncertainty earlier this year is welcome.

26. Ensuring more rapid and inclusive growth will require building support for legislative action. Reforming land acquisition and the GST are the priorities. Easing strict labor regulations will be difficult, but is key to increase formal sector employment.[8] Progress on state-center GST negotiations and the New Manufacturing Policy are encouraging in this regard. In addition, reforms in agriculture, improving health and education, and addressing skills mismatches are needed to increase productivity and make growth more inclusive. These, along with infrastructure, are rightly emphasized in the 12th Plan.

[8] See World Bank (2011) *More and Better Jobs in South Asia*.

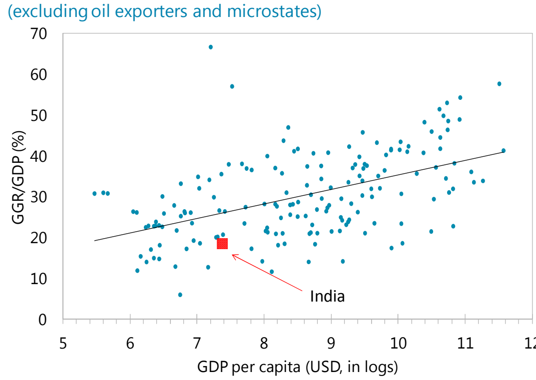
Authorities' Views

27. **The authorities are taking important measures to tackle supply-side problems.** Noting the boost to market confidence, the authorities emphasize that recent measures have sent an unequivocal signal of their determination to reverse the growth slowdown. Supply-side constraints will gradually be eased through the many initiatives under way, as well as through the newly created CCI. With most states having raised energy tariffs this year, discoms' losses have diminished and their improved financial health paves the way for resolving the problems of power producers. The authorities also recognize that market-based pricing and allocation mechanisms would have to play a bigger role in the area of natural resources.

B. Fiscal Policy

General Government Revenue and GDP per capita, 2012

(excluding oil exporters and microstates)



Source: IMF, World Economic Outlook.

28. **As fiscal consolidation remains essential, the FM's medium-term plan is encouraging.** Lower deficits will support monetary policy in fighting inflation, free resources for investment, and lessen vulnerabilities. However, if revenue improvements and subsidy reform do not materialize, either debt will begin to rise or capital spending will be compressed and important social programs underfunded, undermining growth and social goals. At around 0.6–0.7 percent a year, the FM's planned deficit reduction will be slower than that envisaged in early 2010 by the 13th Finance Commission, but given slower growth, this is reasonable. The FM's three percent of GDP medium-term central government deficit is close to that proposed by the 13th Finance Commission and will help rebuild credibility by establishing a fiscal anchor which, if public investment rises as envisaged under the 12th Plan, will approximate a golden rule target. However, reaching this medium-term target will likely take until 2016. The states' deficit is likely to remain around 3 percent of GDP.

29. **A focus on sustainable reforms would rebuild confidence more than reaching deficit targets with one-off measures.** The FM has acknowledged that absent serious measures, consolidation is unlikely, and endorsed the Kelkar Committee's recommendations on improving tax administration and disinvestment. However, reforming fuel and fertilizer subsidies should be the central plank of expenditure rationalization as the Kelkar committee has recommended. With spending pressures, such as for the National Food Security Bill, likely to rise under the 12th Plan, the need to reorient expenditure toward socially and economically productive areas is vital.

30. **Raising revenues to pre-crisis levels has so far proved elusive.** India's revenue-to-GDP ratio has fallen below peers'. The GST would be the most important reform, and would boost growth through the creation of a single Indian market. While there are encouraging signs of a possible GST compromise, the needed legislative changes require a qualified majority, and implementation is not

feasible even in 2013/14. For this reason, at the end of this fiscal year, if the economy has begun to recover and no agreement is reached, it would be appropriate to raise excise taxes. Approving a new Direct Tax Code with streamlined and smaller deductions will also help.

31. Ensuring that consolidation supports growth and social goals will require comprehensive subsidy reform. Recent staff analysis underscores that reorienting expenditure away from untargeted transfers, such as India's fuel subsidies, and government consumption and toward targeted transfers and investment can have strong positive effects on growth (Annex II). On fuel subsidies alone, which are broadly regressive, India currently spends around 2 percent of GDP, including amounts covered by upstream oil companies (Annex III). Introducing market pricing for fuel while protecting the poor would also help reduce fiscal vulnerabilities to oil prices and the exchange rate and lower the CAD. Recognizing the importance of raising spending efficiency, the government has announced a plan to gradually implement direct cash transfers using India's impressive Unique Identification Number (UID), beginning in 2013 in selected districts. As this capability is broadened and targeting improved, the resulting fiscal space should free resources for investment and strengthening the social safety net.

32. Cross-country experience highlights key elements of successful subsidy reform. Embedding subsidy reform within a comprehensive structural reform agenda aimed at addressing supply-side inefficiencies and bottlenecks can generate broad public support. Successful subsidy reforms in Brazil, the Philippines, South Africa, and Turkey were part of broad overhauls of the energy sector. An effective public information campaign should clearly identify the shortcomings of subsidies and explicitly link planned increases in priority public spending to savings from subsidy reform. Subsidies should also be one component of a comprehensive agenda aimed at strengthening the safety net, including specific mechanisms for compensating the poor.

Authorities' Views

33. The government is strongly committed to reaching this year's 5.3 percent of GDP modified budget deficit target. Recognizing the overhang from the 2008/09 crisis, they stress that the political risk taken in raising diesel prices indicates clearly their commitment to fiscal consolidation. While acknowledging that tax revenues are likely to be affected by the slowing economy, they believe that this, as well as potential overruns in subsidies, can be countered by identified savings on Plan spending, stronger tax administration efforts, and innovative disinvestment modalities, containing this year's overrun to around ¼ percent of GDP compared to the budget.

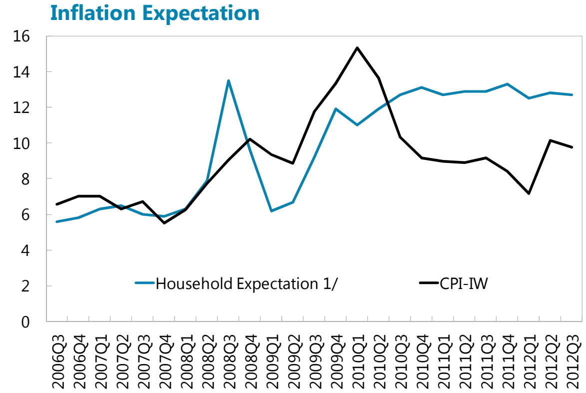
34. The medium-term consolidation plan is also attainable. The FM's medium-term consolidation roadmap demonstrates that the government attaches the highest priority to lowering deficits to bring the economy back on a high growth trajectory. The authorities believe that stronger growth will buoy tax revenues, allowing fiscal consolidation to be accompanied by a pro-growth and pro-poor reorientation of spending. On subsidy reform, various pilot schemes are under way to move toward direct cash transfers and the use of the UID to replace current delivery mechanisms. They expect that by 2016/17 cash transfers are expected to be in place for key subsidies, which will reduce the fuel and fertilizer subsidy bill. The authorities also remain focused on introducing the GST, which should greatly improve efficiency and support revenues.

C. Monetary and Exchange Rate Policy

35. With inflation still high, monetary policy can best support growth by staying the course. Growth has slowed more than expected and is below even the lowest estimates of potential growth, with sizable downside risks. Also, as high nominal lending rates are hurting highly leveraged corporates, there is a strong expectation for the RBI to cut policy rates further to support growth. However, interest rates do not seem to be a major cause of the investment slowdown, and it is unlikely that lowering them before other roadblocks are removed would spur investment (Box 6). Despite some moderation, inflation pressures remain significant, and short-term real interest rates are barely positive. Inflation inertia is strong, and a disinflation to 5–6 percent, a level not associated with detrimental effects on growth, would require perseverance with a sustained period of relatively subdued aggregate demand.[9] Hence, on balance, it is appropriate to keep policy rates at current levels until the inflation decline is clear and sustainable.

36. Consideration could be given to measures that could help anchor inflation expectations. The RBI's WPI projections announced at the beginning of the fiscal year have been exceeded for the past three years. The higher weight of food in household expenditure has kept CPI, which informs household expectations, consistently above WPI. In addition, food price shocks propagate strongly into nonfood inflation. Hence, it would be desirable for the RBI to express its projections and objectives in terms of the national CPI as soon as the data allow. Additionally, the RBI could maintain rolling one-year projections, and, while taking high inertia into account, explain a credible path toward the RBI's longer-term goal of 3 percent.

Inflation Expectation



Source: Reserve Bank of India
1/ Inflation expectation for next FY

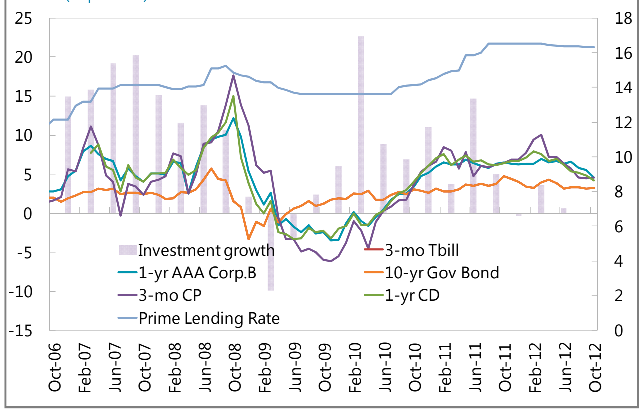
37. The floating rupee is an important shock absorber. Rupee flexibility has offset inflation differentials and prevented exchange rate misalignment. Such flexibility would be particularly important in case of renewed global financial stresses. Going forward, lower inflation and a lower fiscal deficit would reduce external vulnerabilities, as will easing supply bottlenecks that would reduce import demand and spur exports. Consideration could also be given to promoting financial instruments—such as inflation-indexed bonds—to reduce gold demand as an inflation hedge.

[9] In line with previous RBI studies, India Staff Report for the 2012 Article IV consultation (Box 5, IMF Country Report No. 12/96) found that inflation above 5–6 percent hurts growth.

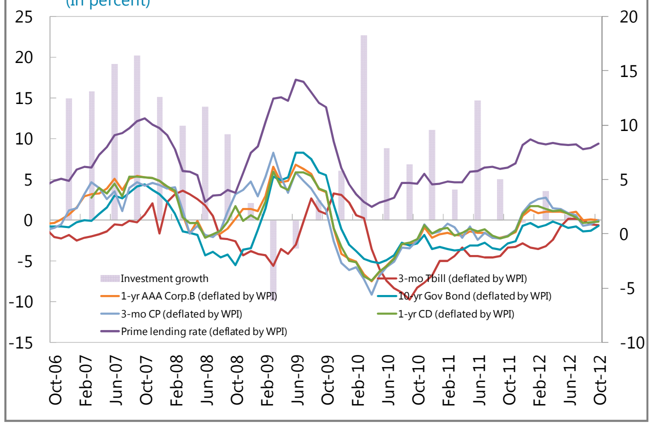
Box 6. The Role of Interest Rates in the Current Investment Slowdown[1]

The recent investment slowdown has sparked an intense debate in India about the role of interest rates. Economists typically argue that real interest rates have been low, even though nominal rates have gradually risen after the substantial easing of 2008/09. On the other hand, some representatives of the business community maintain that high nominal lending interest rates have been an important cause of the investment slump. Not surprisingly, the two groups argue for different courses of monetary policy.

Nominal Interest Rates
(In percent)



Real Interest Rates
(In percent)



Where are interest rates in India? Money market rates, including bank CDs, yields on government bonds and highly-rated corporate bonds, and commercial paper are barely above WPI inflation. In real terms, these rates are significantly lower compared to the mid-2000s when investment boomed. Real bank lending rates appear only about 20 bp higher.[2] An RBI report suggests that the real weighted average lending rate is 300 bp lower than the average in 2003/04 to 2007/08. However, for certain sectors of the economy, where structural or cyclical factors impede output price adjustments, sector-specific real interest rates exceed real interest rates based on aggregate inflation expectations.

Staff analysis suggests that real interest rates explain economy-wide investment activity better than nominal interest rates.[3] The overall fit of the investment equation improves when real interest rates are included relative to the nominal interest rate specification.

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[1] Based on a forthcoming IMF working paper by Rahul Anand and Volodymyr Tulin.

[2] This is based on the prime lending rate. This is the longest data series available, and these rates are higher than the upper end of the median lending rates. The base rate, introduced in July 2010, is at 10.5 percent.

[3] A similar set of corporate investment determinants is identified in Tokuoka (2012), IMF WP/12/70, "Does the Business Environment Affect Corporate Investment in India?"

Box 6. The Role of Interest Rates in the Current Investment Slowdown (concluded)

Also, once nominal interest rates and inflation expectations are included together as explanatory variables, they appear to have statistically indistinguishable impact on investment with opposite signs after controlling for other relevant explanatory variables, which corroborates the economic importance of real interest rates. Finally, when real interest rate and inflation expectations are included in the same specification, the latter does not improve the explanatory power of the regression.

Staff estimate that about one quarter of the explained slowdown in investment growth can be attributed to higher real interest rates. Importantly, the regression analysis explains over half of the total investment slowdown witnessed during this period, but systematically over-predicts investment in the past two years, suggesting that other factors, such as supply bottlenecks, are also at play. An alternative estimate, based on a structural VAR, confirms these findings.

Table 1. Regression Analysis of Investments

Dependent Variable: Change in real gross fixed capital formation (quarter-over-quarter percent change, seasonally adjusted)

	(1)	(2)	(3)	(4)
Real interest rate	-0.824 ***			-0.837 **
% per annum	(0.298)			(0.337)
Nominal interest rate		-0.417 **	-0.782 **	
% per annum		(0.161)	(0.270)	
Inflation expectations			0.896 *	0.069
%, next fiscal year			(0.533)	(0.261)
Business confidence	0.045 **	0.027	0.046 **	0.046 **
NCAER index	(0.020)	(0.019)	(0.218)	(0.022)
Capital goods cost inflation	-0.971 **	-0.970 *	-0.960 **	-0.962 **
% change in ratio of GFCF to GDP deflators	(0.478)	(0.507)	(0.447)	(0.446)
Inflation volatility	-0.139 *	-0.002	-0.156	-0.155
12-month st.dev of m/m saar % changes	(0.082)	(0.099)	(0.103)	(0.103)
Change in VIX	-0.099 **	-0.107 **	-0.099 ***	-0.099 ***
unit change	(0.038)	(0.042)	(0.035)	(0.035)
Global GDP growth, lag	-0.519	0.075	-0.544	-0.556
q/q % change, s.a.	(1.013)	(1.062)	(1.000)	(1.007)
Constant	3.728	4.333 *	3.029	3.361
	(2.317)	(2.504)	(2.364)	(2.367)
Sample: 1996Q2-2012Q2				
Number of observations	64	64	64	64
R^2, d.f. adjusted	0.212	0.173	0.198	0.198

Source: IMF staff estimates.
Note: Interest rate corresponds to the average prime lending rate. Real interest rate is based on inflation expectations for the next fiscal year from Consensus Economics surveys.
Note: Robust standard errors in parenthesis.
Note: ***,**, * indicates 1,5, 10 percent statistical significance, respectively.

38. **Further opening of FDI and local capital markets is welcome, but certain relaxations of external commercial borrowing (ECB) can increase external vulnerabilities.** Greater FDI liberalization could increase this more stable funding source. In addition, continuing to raise the Foreign Institutional Investor (FII) debt quotas contributes to deepening domestic capital markets. While this may increase domestic interest rate volatility, it provides financing with foreign investors bearing the FX risk. The authorities have also relaxed several ECB regulations, including for sectors without natural FX hedges. And the lower withholding tax on rupee corporate bonds is a positive step, but the framework is still skewed toward ECBs, especially loans. Finally, the flexible rupee has increased incentives to hedge, but with corporates still reported to have substantial unhedged FX exposures, some easing of restrictions that have reduced the depth of the onshore FX forwards and futures markets would be beneficial. In the longer run, inclusion of Indian bonds in global indices would attract funds from long-term investors, and the requirements for this could be explored.

Authorities' Views

39. The RBI emphasizes that inflation and inflation expectations have moderated, but remains concerned about the level of inflation. The RBI deems that pricing power has diminished, that much of the inflationary effects of the rupee depreciation have worked through the economy, and that the pass-through from food and other commodity prices to broader inflation is relatively weak, making inflation dynamics more favorable going forward. However, the RBI views the persistence of inflation, which it attributes in part to supply constraints, in the face of weak growth as a key challenge.

40. As inflation eases further, the RBI sees an opportunity for monetary policy to be eased. The RBI sees contrasting forces shaping the inflation outlook. Slower growth and excess capacity in some sectors are expected to lower inflation, while supply bottlenecks and wage increases could keep inflation pressures elevated. On balance, the RBI expects inflation to recede after the administrative price increases to fuel and electricity have fully passed through and has provided guidance for policy easing in the first quarter of 2013.

41. The RBI will continue its multiple-indicator approach and does not see an immediate need for broadening inflation guidance. Communication has recently been shifted toward the CPI, but the RBI will continue to use its multiple-indicator approach in assessing inflation dynamics and trends. While acknowledging this complicates effective communication, they note that the short time series for the CPI makes it as yet inadequate as a headline measure, though its role is expected to increase over time. Uncertainty about the patterns and magnitude of seasonal effects, such as the monsoon, complicates both rolling y/y projections and momentum indicators, which can be biased by miss-estimation of underlying seasonal factors and would undermine the credibility of the RBI.

42. The authorities are concerned about external vulnerabilities. While they agree that the current account for the time being can be financed, they deem that with GDP growth at about 7 percent, the sustainable current account is -2.5 percent of GDP. They point to still-high commodity prices, especially for oil, and strong demand for gold as significant risks to the external outlook. The authorities note that the RBI's policy of allowing the rupee to float freely means that reserves are no longer being accumulated, and that while reserves ratios are therefore falling, they remain adequate to face sudden stops in capital flows and counter increased exchange rate volatility.

43. The rupee will continue to float, and further capital account liberalization will be undertaken cautiously. The RBI remains committed to allowing the rupee to float. The authorities plan to continue their focus on liberalizing capital inflows with a view to facilitating the financing of infrastructure and building the corporate bond market while paying attention to prudential aspects. Similarly, some relaxation of restrictions on FX forwards might be considered, but will depend on the volatility of the exchange rate.

D. Financial Policies

44. With credit risks rising, mechanisms for addressing deteriorating asset quality should be tightened. The RBI is considering the Mahapatra WG's recommendations, which would constitute improvement. These, however, would still leave India's treatment of restructured assets relatively lenient, as best practices suggest bank portfolios should recognize true asset quality. Restructured loans should generally be classified as nonperforming upon restructuring, and categorized as performing only after a period of satisfactory performance. This would likely require greater loss write-offs and higher provisions. Favored sectors, such as infrastructure, should not receive preferential treatment. In addition, strengthening the credit culture could reduce the incidence of NPAs in priority sector lending, which are now responsible for about 50 percent of total public banks' NPAs. Finally, the FSAP recommended improving the performance and financial strength of public financial institutions and subjecting them to full supervision and regulation.

45. Medium-term capital requirements for public banks could be higher than currently estimated. The table below shows the results from converting 15, 30, and 45 percent of restructured assets into NPAs, with these assets provisioned at each institution's current provisioning rate, but at a minimum of 70 percent. In the 45 percent case, public banks' average tier 1 capital adequacy ratio would fall to 7.4 percent, below the 8 percent required for a bank to be considered well-capitalized under Basel III as of January 2015. The percentage of public sector banks below 8 percent Tier 1 capital would be 90 percent of the total, with 10 percent of public sector banks below the 10 percent threshold for well-capitalized banks' Tier 1 and Tier 2 ratio. If capitalization needs for public banks prove challenging, consideration should be given to reducing the government's stake.

Table. Stressing Indian Banks' Balance Sheets

	Public Sector Banks				Private Banks			
Share of Restructured Loans -> Impaired (%)	Average Impaired Loan Ratio 1/	Average Tier 1 Capital Ratio	Share of Banks Below 8% Tier 1	Share of Banks Below 10% Tier 1 + Tier 2	Average Impaired Loan Ratio 1/	Average Tier 1 Capital Ratio	Share of Banks Below 8% Tier 1	Share of Banks Below 10% Tier 1 + Tier 2
15	1.9	8.7	25	0	0.6	11.8	0.0	0.0
30	2.2	8.1	60	5	0.7	11.7	0.0	0.0
45	2.4	7.4	90	10	0.7	11.6	0.0	0.0

Sources: RBI and staff calculations.

1/ Impaired loans after provisions over outstanding loans.

46. Reducing concentration risk is necessary to support higher growth and broader access to credit. Large and related party concentration exposure limits remain inconsistent with international practices, and resulting high exposures curtail the ability of banks to underwrite new investment, especially in large projects such as infrastructure (Annex IV). To reduce concentration risks, advances and commitments to interrelated companies should be appropriately measured and limited, and these limits enforced. Further development of the corporate bond market, which requires domestic institutional investors' greater participation and greater liquidity—most likely from FII participation—would advance this goal by supporting securitization and providing alternative long-term financing. Further development of infrastructure debt funds should free space on balance sheets, as would greater take-out financing, and credit enhancements for project financing.

47. Strengthening creditor rights and the insolvency framework, as proposed by the FSAP, has become more urgent. Stronger creditor rights would increase lenders' leverage, providing creditors with greater certainty of repayment and increasing recoveries, which now average well below advanced-economy levels. This would also constitute a step toward a better functioning corporate bond market and distressed asset market. Additional incentives that could facilitate deeper corporate restructuring as opposed to debt rescheduling and induce the resolution of impaired assets could be considered.

48. Over the medium term, other financial sector reforms, especially lowering the SLR, are important to lower the cost of capital for companies and broaden access to financial services. The SLR lowers borrowing costs for the government while keeping them high for private companies (Box 7). As fiscal deficits decline, the SLR should also be gradually reduced, freeing financial institutions' funds for loans to companies and households. Lowering the SLR, along with reducing similar mandates on institutional investors, will also help develop the corporate bond market. Approval of the Pension Fund Reform and Development Authority Law and modifying insurance regulations would also encourage the growth of domestic institutional investors and deepen markets for long-term borrowing.

Authorities' Views

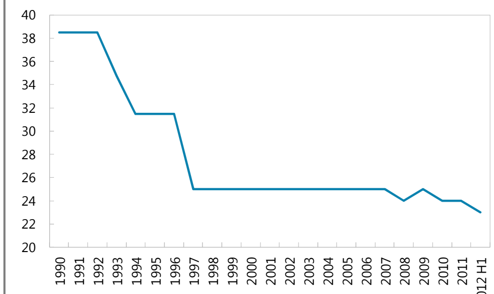
49. The authorities agree that balance sheets have worsened, but believe that they do not represent a systemic risk. Recent RBI stress tests for banks show that even under a scenario in which 30 percent of restructured advances become NPAs, which the authorities view as extreme, bank stress remains contained and banks sufficiently capitalized. The authorities also underscore banks' improved risk management and supervisory authorities' assiduous monitoring and strict enforcement. The RBI also notes that from their extensive surveys the leverage of the broad corporate sector has not risen and the increase in leverage concerns mainly large companies with relatively safe access to finance. Hence, while the authorities are monitoring developments, they do not see this as an immediate risk.

50. The regulatory framework for restructured assets continues to be refined. The authorities have increased provisioning and focused on improved information sharing among banks. They emphasize that debt restructurings most often follow unforeseen external developments that have delayed project implementation, and are approved only when the bank determines that the account become viable after restructuring. Further, loans in sensitive sectors (capital markets exposure, personal loans, and commercial real estate) cannot be restructured in this way, due to higher potential risks. The authorities agree, though, that the rising level of NPAs warrants further provisioning, and note that further recommendations of the Mahapatra WG are under consideration.

Box 7. India's Statutory Liquidity Ratio[1]

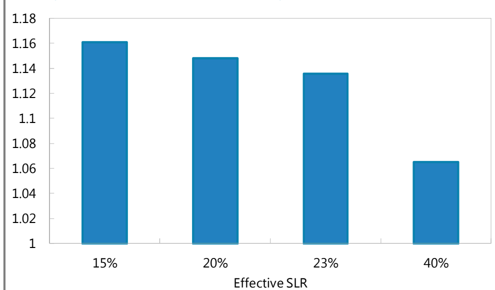
The Statutory Liquidity Ratio (SLR) in India entails large holdings of government securities on financial institutions' balance sheets. After being reduced over time, the SLR currently requires banks to invest 23 percent of net demand and time liabilities (NDTL) in government securities (G-Sec). Also, banks can keep 25 percent of NDTL in G-Sec without marking to market. In addition, insurance companies and pension funds have similar but higher requirements. Based on these restrictions on portfolios, the effective SLR for the whole economy is around 50 percent of financial sector liabilities, providing an assured source of financing for the government.

Statutory Liquidity Ratio (for banks)
(In percent)



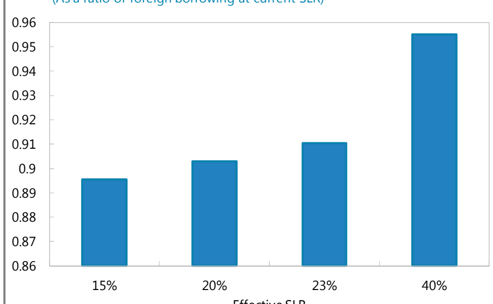
Sources: Bloomberg

Investment Under Different SLRs
(As a ratio of investment at current SLR)



Sources: Staff estimates.

Foreign Borrowing Under Different SLRs
(As a ratio of foreign borrowing at current SLR)



Sources: Staff estimates.

An estimated DSGE model is used to analyze the SLR impact on the economy. The model assumes that the SLR is binding and financial institutions are profit-maximizing. Banks' holding of G-Sec has exceeded the mandated SLR requirement because only G-Sec in excess of SLR can be repoed for liquidity management. While it is difficult to determine whether the SLR binds in practice, there are indications that it is binding at least for some institutions, especially private ones. Even if banks were to continue holding G-Sec once the SLR is lowered, they would likely do so at a higher yield.

The model suggests that lowering the SLR could result in higher investment over the medium term. The SLR is found to lower government borrowing costs, while increasing those for the private sector. A 10 point reduction in the effective SLR is likely to lower the borrowing costs for the private sector by around 100 bp, while increasing the borrowing costs for the government by 50 bp over the medium term. Lower borrowing costs could result in a 5 percent increase in investment over the medium term. Similarly, in terms of welfare, a 10 point reduction in the effective SLR should improve welfare by 0.2 percent. In addition, the SLR is found to have increased external borrowing. The model suggests that increased domestic borrowing costs and lowered availability of domestic financing due to the SLR have encouraged corporates to borrow abroad. Staff's model suggests that reducing the effective SLR by 10 percentage points would reduce foreign borrowing by corporate by around 4 percent in the medium term.

[1] Based on a forthcoming IMF working paper by Rahul Anand, Hautahi Kingi, James P. Walsh, and Tianli Zhou.

51. Capital market reform retains its high priority on the reform agenda. The authorities remain committed to promoting the development of the corporate bond market, facilitating ways to free banks' balance sheets to enable them to finance new infrastructure projects, and to broadening access to financial services. They are planning to ease asset allocation norms for insurance companies and pension funds and allow greater FDI in these sectors. They also expect that the planned infrastructure debt funds, take-out financing, and the credit enhancement schemes being considered can help lower concentration and sectoral exposures. The authorities note that the SLR has been lowered this year and that it could be further recalibrated in accordance with evolving monetary and fiscal conditions.

STAFF APPRAISAL

52. The near-term outlook is for subdued growth and elevated inflation. Recognizing the economy's challenges, the authorities have announced measures to revive growth, and reiterated their commitments to lowering the fiscal deficit and inflation. Nevertheless, as investment has been particularly hit and supply constraints will likely be eased only gradually, the recovery is likely to be muted and inflation and the current account deficit are expected to fall only gradually.

53. Risks are on the downside, but upside risks have emerged. The uncertain global situation could present serious challenges to India. At the same time, the macroeconomic environment reduces the scope for policy response. Ongoing structural reforms present both upside and downside opportunities: a faster pace of reform could entail higher growth, while insufficient follow-through would weigh heavily on the outlook.

54. Delivering on structural reforms, fiscal consolidation, and low inflation are critical for a sustained recovery. Weak demand is not the main cause of the slowdown and, with little space for countercyclical action, policy stimulus through fiscal or monetary expansion is inadvisable. Maintaining reform momentum, delivering durable fiscal adjustment, lowering inflation, and addressing vulnerabilities will return India to high growth, even against the backdrop of lackluster global growth.

55. The government has put the reform process in motion, and the next steps should aim at issues in energy and natural resources. Measures taken have begun to improve the business climate. Further boosting growth will require addressing shortcomings in the energy sector, such as through full cost-recovery pricing and greater efficiency of electricity distribution companies and addressing power plants' fuel linkages. More broadly, moving the pricing and allocation of natural resources toward a market basis would improve transparency and efficiency, boosting investment.

56. Addressing additional structural roadblocks and long-term challenges is also crucial. The newly created CCI is expected to accelerate approvals for large investment projects. Greater policy predictability is needed to boost investor confidence. Legislative action such as the Goods and Services Tax (GST) and an effective land acquisition law are priorities. In addition, easing restrictive labor laws, as well as measures to support agricultural productivity, improve health and education outcomes, and address skills mismatches, would contribute to making growth more inclusive.

57. The government's fiscal roadmap is welcome, but the quality and sustainability of consolidation are more important than meeting short-term targets. The pace of consolidation, particularly given the slowing economy, and the medium-term budget deficit target are appropriate. Reaching the target will require revenue to rise to pre-crisis levels, through more efficient taxation and ideally also through the GST. Though recent initiatives tying India's safety net to the impressive UID Program are encouraging, reorienting spending toward 12th Plan priorities without endangering deficit targets requires comprehensive reform to fuel and fertilizer subsidies.

58. The RBI's vigilance on inflation will pay dividends for long-term growth. With financial conditions still relatively easy, it is appropriate to maintain the current level of policy rates until inflation is clearly on a downward trend. As data improve, shifting projections and guidance to the new CPI will help anchor expectations, but in the meantime, the RBI should consider providing rolling one-year ahead inflation projections.

59. Rupee flexibility and continued gradual opening of the capital account are welcome, though policies could be optimized to lower external vulnerability. From a medium-term perspective, India's external position is broadly in line with fundamentals and desired policies, but the recent deterioration of the CAD exposes India to sudden stops in capital inflows and calls for policy tightening, especially of fiscal policy, to reduce overall external vulnerability. Rupee flexibility will remain important to offset inflation differentials and help absorb external shocks. Continued capital account opening, particularly if focused on FDI and rupee bonds, would improve the current account deficit financing mix and deepen domestic capital markets. But relaxation of external commercial borrowing should be allowed cautiously, especially for sectors without natural FX hedges.

60. Unless rising financial sector risks, especially concerning asset quality and concentration, are decisively addressed, banks may be unable to support higher medium-term growth. Full implementation of the RBI working group's recommendations on restructured assets is needed, as well as stricter classification, and higher provisions and loss write-offs without making exceptions for favored sectors. Consideration should also be given to measures to facilitate deeper corporate restructuring and to strengthen the insolvency framework. Large and related party concentration exposure norms should be brought in line with international practices and interrelated companies and FX exposures keenly monitored. As the FSAP recommended, improving the financial strength of public banks is particularly important.

61. Other financial sector reforms are needed to strengthen the financial system's contribution to growth. While currently well-capitalized, public banks will likely require substantial capital injections. In addition, concentration of bank lending and the need to broaden access to credit point to the need to deepen corporate bond markets. Over the longer term and as the fiscal deficit falls, the statutory liquidity ratio should also be lowered.

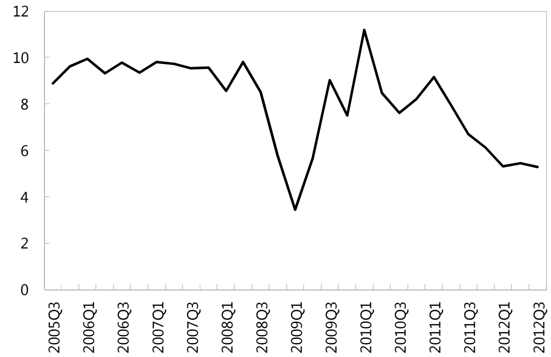
62. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. India: Growth Slowdown

The growth slowdown has become generalized and has led to large downward revisions in projections.

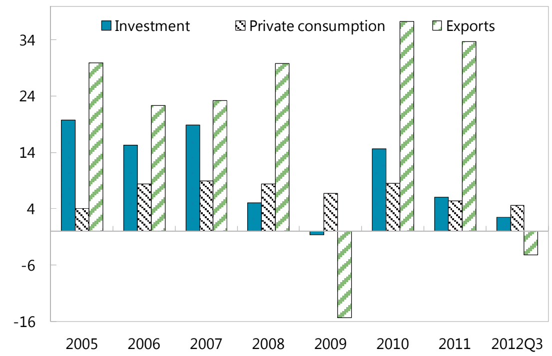
GDP growth has decelerated sharply over the past year and half.

GDP Growth
(In percent, yoy)



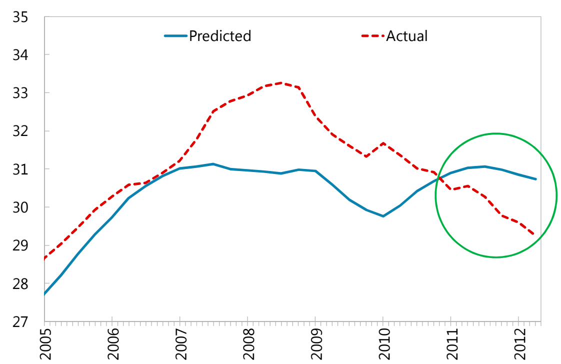
What started as an investment slump has now become a generalized slowdown.

Demand Components of GDP
(In percent, yoy)



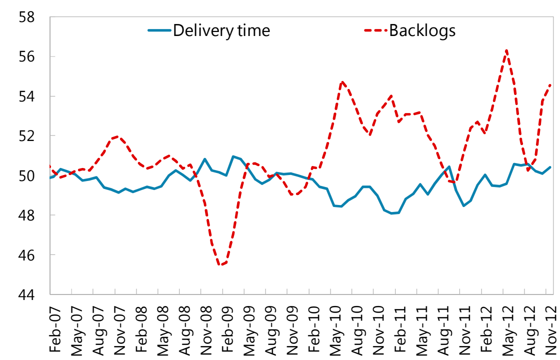
Standard macro variables (growth, interest rates, global growth, and the VIX) do not fully explain the recent investment deceleration…

India: Actual and Predicted Investment
(In percent of GDP, 4 mma)



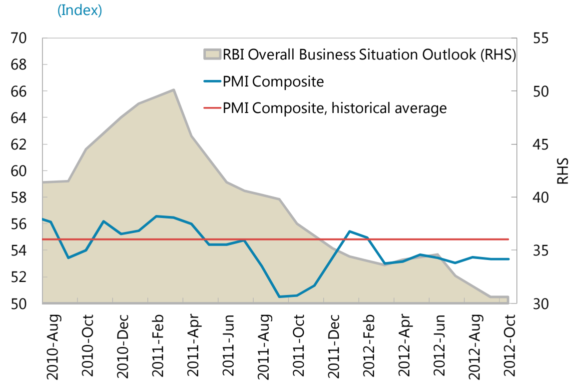
…and there are indications that supply bottlenecks are constraining growth.

India PMI Manufacturing Indicators
(3mma, >50 indicates an expansion)



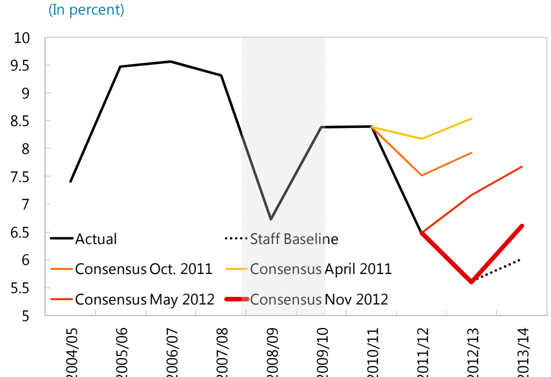
High frequency indicators have stabilized, but remain weak.

PMI Indices and Business Expectations
(Index)



As a result, India's growth projections have been repeatedly adjusted downward.

GDP Growth
(In percent)



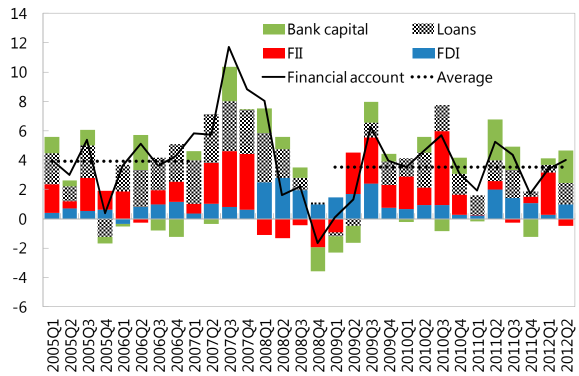
Sources: Haver Data Analytic; CEIC Data Company Ltd; and IMF staff calculations.

Figure 2. India: Financial Markets

Capital flows have held up so far. External vulnerabilities have taken a toll on the rupee, though recent measures have improved market sentiment across markets.

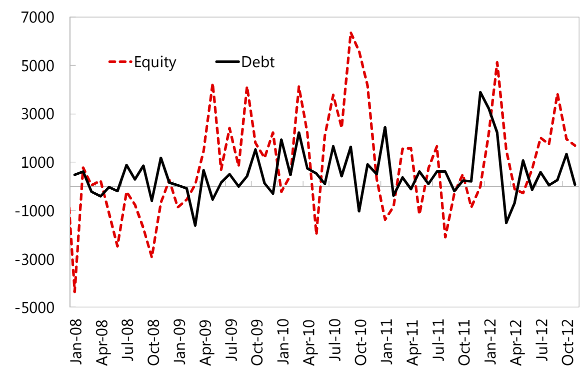
Capital flows have remained buoyant…

Financial Account
(In percent of GDP)

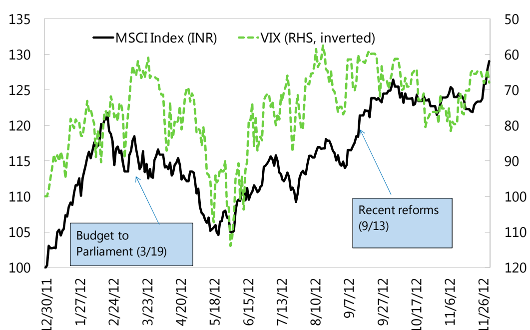


…though volatile.

FII Flows
(In millions of US$, monthly)

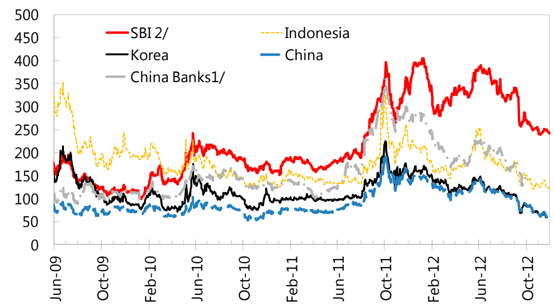


Indian equities performed well in line with global risk aversion, but have also responded to key domestic developments.



A proxy CDS for the Indian sovereign had decoupled from other EMs, but has tightened recently.

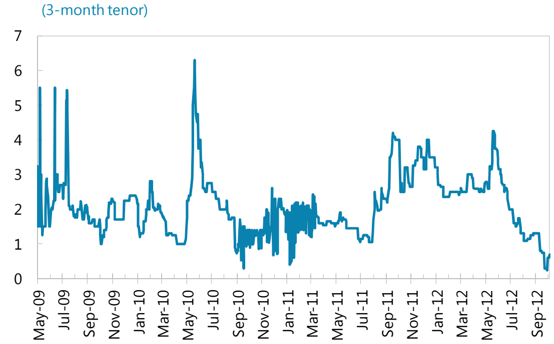
Credit Default Swap: SBI versus Sovereigns
(Basis points)



1/ Average of Bank of China and China Development Bank.
2/ SBI is used as proxy for Government of India.

Risk reversals have been indicating greater bullishness for the rupee recently…

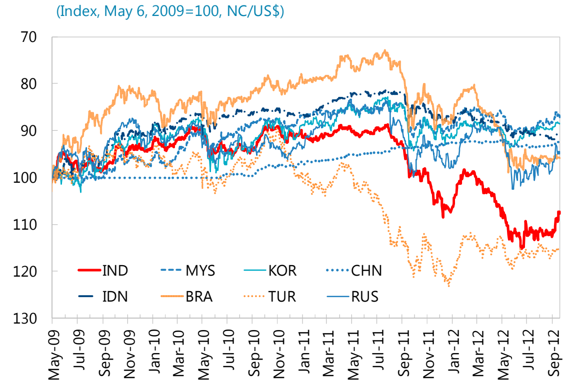
Foreign Exchange Risks Reversals 1/
(3-month tenor)



1/ Difference in implied volatility between call and put options on USD/INR options.

…and after depreciating more than most EM currencies, the rupee has recovered lately.

Exchange Rate
(Index, May 6, 2009=100, NC/US$)



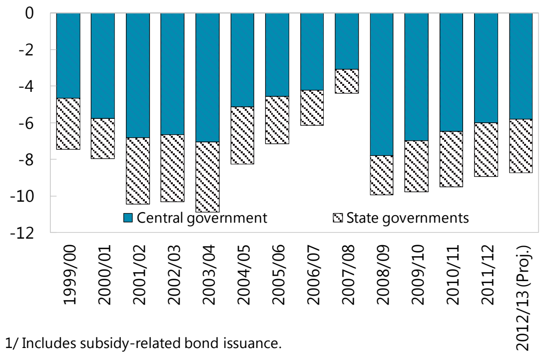
Sources: Bloomberg Data LP; CEIC Data Company Ltd.; and IMF staff calculations.

Figure 3. Fiscal Sector Developments

A slow consolidation after the financial crisis has come to a halt. Ensuring stable debt dynamics will require measures to contain current expenditure and raise revenue.

The budget deficit has been falling only marginally since the global financial crisis.

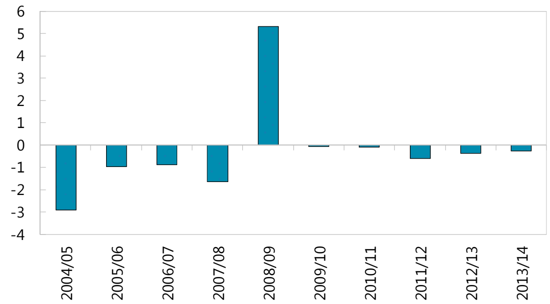
Government Balance
(In percent of GDP) 1/



1/ Includes subsidy-related bond issuance.

Following the rapid crisis-period expansion, the fiscal stance has been broadly neutral.

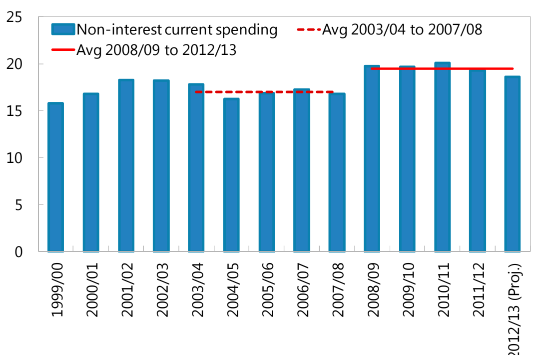
General Government Fiscal Impulse 1/
(In percent of GDP)



1/ Defined as difference between current and previous year budget deficits, using business cycle-adjusted revenues.

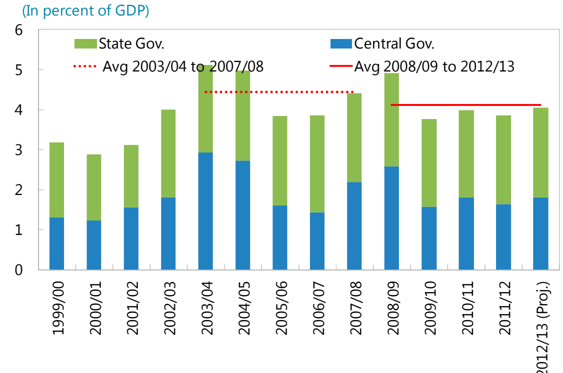
Current spending reached a new plateau during the crisis and has fallen only slowly.

General Government Non-interest Current Spending
(In percent of GDP)



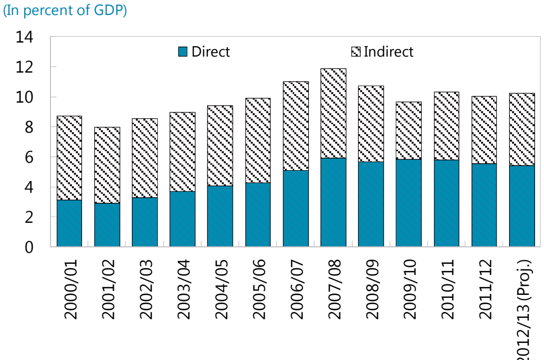
On the other hand, capital spending is slightly lower than before the crisis.

Capital Spending
(In percent of GDP)



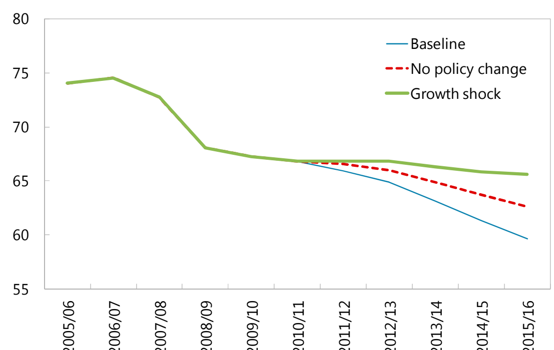
Revenue remains below levels reached before the global financial crisis.

Central Government Revenue
(In percent of GDP)



With the deficit still high, a shock to growth could bring consolidation to a halt.

General Government Debt
(In percent of GDP)



Sources: Country authorities; and IMF staff calculations.

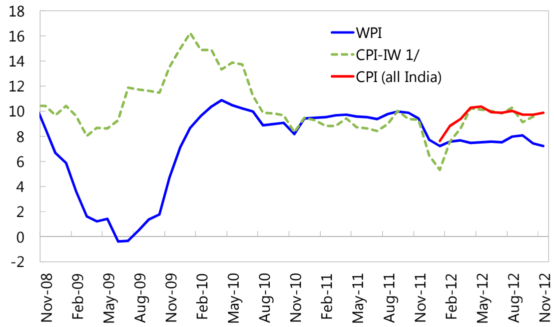
Figure 4. India: Monetary Policy

Though they have moderated, inflation pressures remain sustained. Monetary conditions have eased. However, as the output gap is expected to widen due to weak growth, keeping policy rate at current level is appropriate.

Despite a moderation in late 2011, inflation remains elevated and sticky…

Inflation

(In percent, yoy)

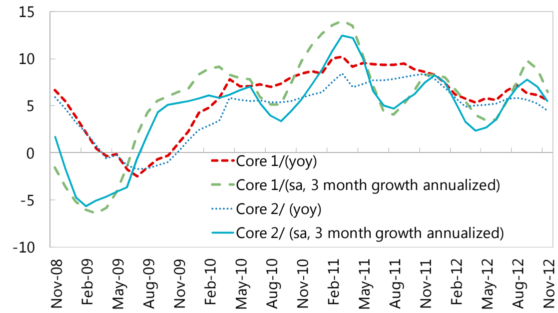


1/ Industrial Workers.

…and momentum in core inflation remains strong.

Core Inflation Trend

(In percent)

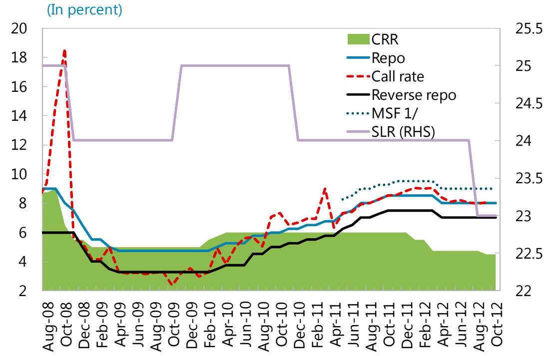


1/ Excluding foods and energy.
2/ Manufacturing excluding foods.

After tightening in 2010–11, the RBI has cut the policy rate in April and has eased liquidity.

Interest Rates

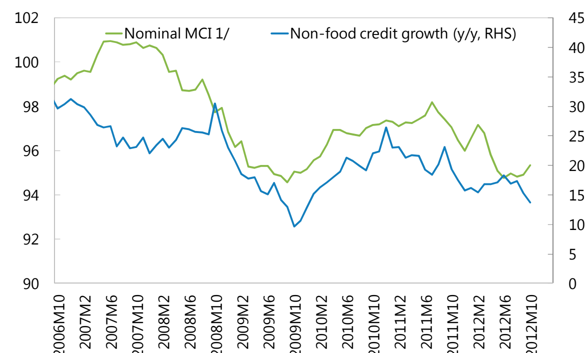
(In percent)



1/ RBI introduced MSF in May 2011. Since then, liquidity management has improved.

Monetary conditions have eased aided also by the rupee depreciation, but credit growth has slowed partly reflecting increased credit risks.

Monetary Conditions

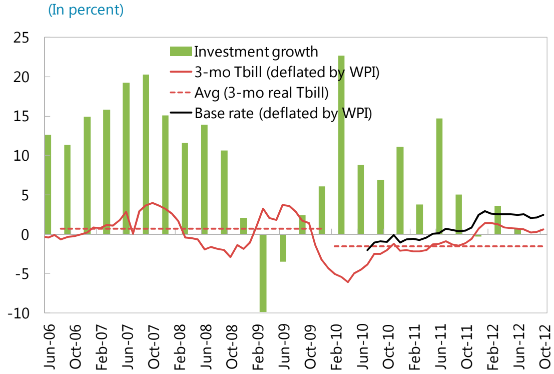


1/ 2007=100. An increase represents tightening.

Real rates have increased, but they continue to be low.

Investment and Real Interest Rate

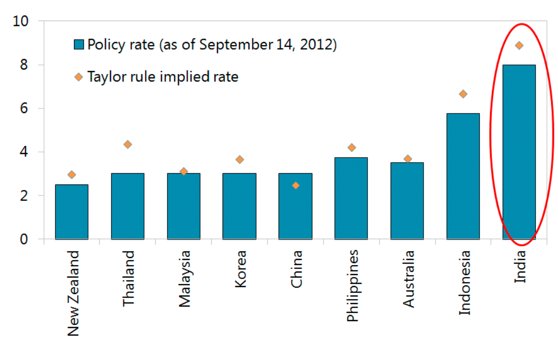
(In percent)



The policy rate is lower than implied by a Taylor rule, but the output gap is expected to open.

Selected Asia: Nominal Policy Rates and Taylor Rule Implied Rates

(In percent)



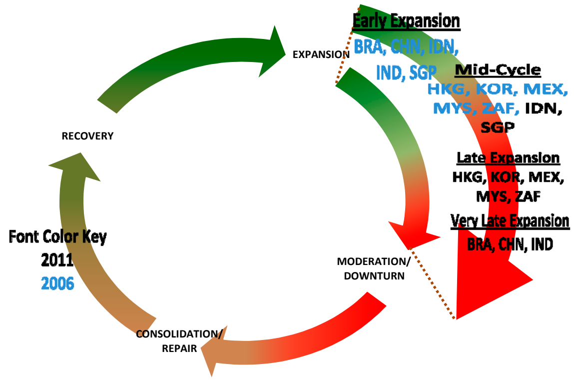
Source: IMF staff calculations.

Sources: CEIC Data Company; Bloomberg Data LP.; and IMF staff calculations.

Figure 5. India: Banking Sector

The banking system has seen a significant deterioration in asset quality, with public banks underperforming private banks.

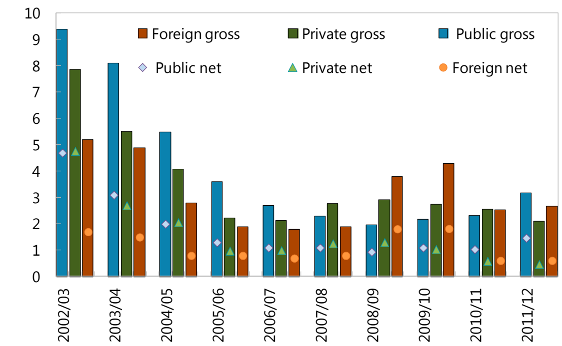
India is in the late stages of a credit cycle…



Sources: October 2010 Global Financial Stability Report
Note: Cyclical position estimated from indicators including credit/GDP, real house price changes, equity price/book value, gross NPLs and ROA, corporate debt/equity ratio and ROE.

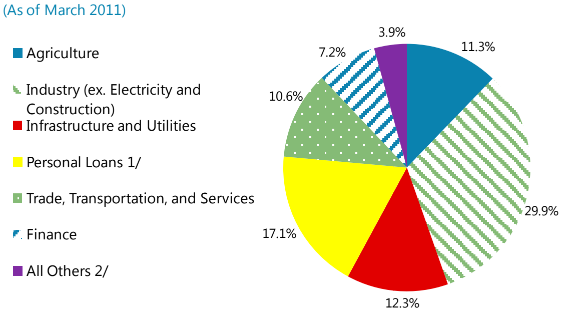
…resulting in higher NPAs, especially at public banks.

Commercial Banks NPAs
(In percent)



State owned banks' loan books are more concentrated in the weaker sectors of the economy…

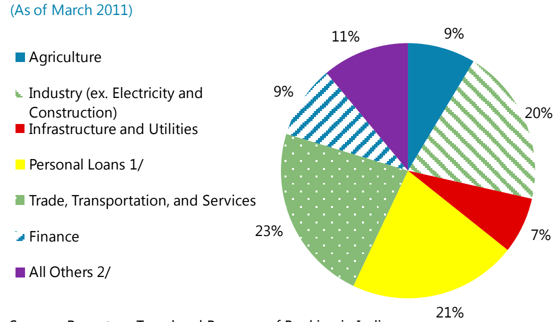
State Banks' Loan Distribution
(As of March 2011)



Sources: Report on Trend and Progress of Banking in India.
1/Includes mortgages.
2/Includes commercial construction loans.

…compared to private banks' books.

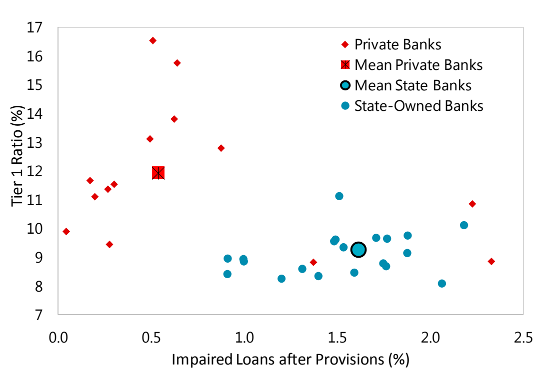
Private Banks' Loan Distribution
(As of March 2011)



Sources: Report on Trend and Progress of Banking in India.
1/Includes mortgages.
2/Includes commercial construction loans.

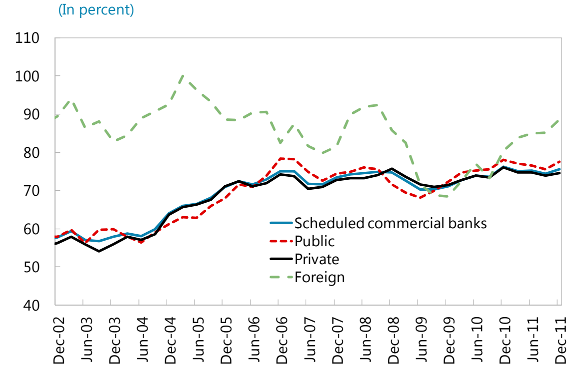
Together with lower Tier 1 capital ratios, public sector banks are therefore more vulnerable…

Loan Impairments vs. Tier 1 Ratio



…while the loan-to-deposit ratio for both private and state owned banks has crept back up to 2007 highs.

Loan to Deposit Ratio
(In percent)



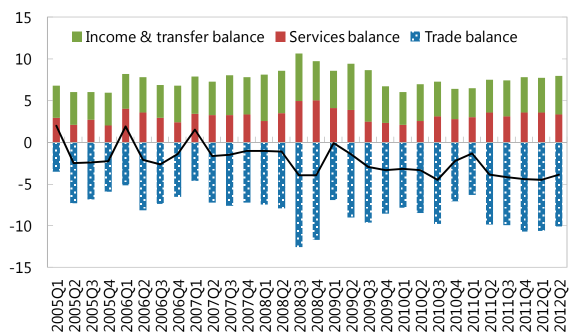
Sources: Country authorities; Bloomberg Data LP.; Bankscope; CEIC Data Company; Thompson Reuters Datastream; and IMF staff calculations.

Figure 6. India: External Vulnerabilities

External vulnerability has increased, though it remains manageable.

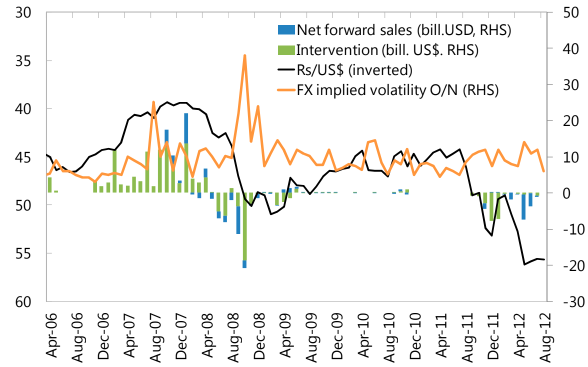
The current account deficit widened to a historical high on the back of a rising trade deficit...

Current Account Balance
(In percent of GDP)



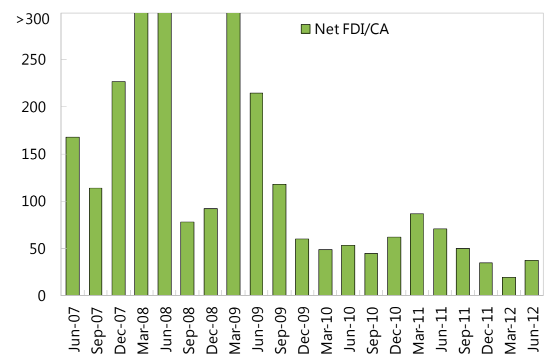
...causing the rupee to plunge despite RBI intervention, before stabilizing recently.

Exchange Rate and Intervention



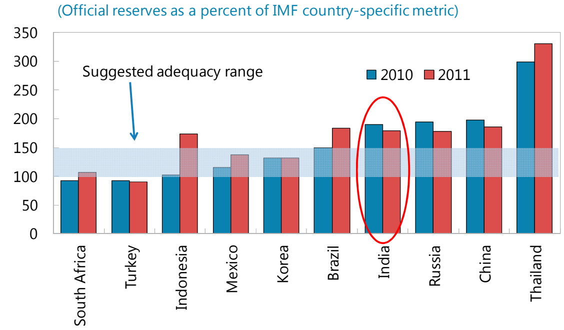
The composition of the current account deficit financing has worsened.

Foreign Direct Investment
(In percent of current account)



Although the reserve coverage is adequate...

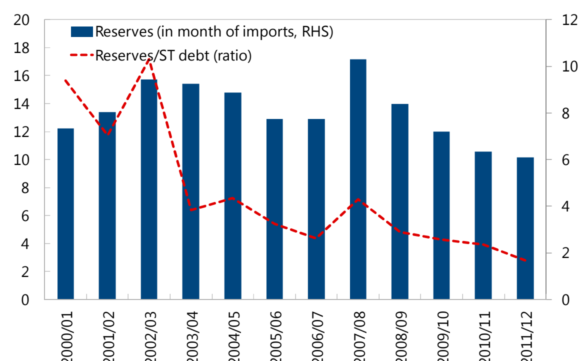
Estimated Reserve Adequacy
(Official reserves as a percent of IMF country-specific metric)



Sources: IMF, International Financial Statistics, and IMF staff calculations.

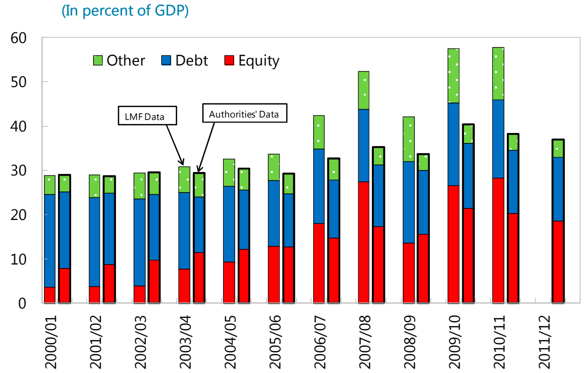
...it has deteriorated.

Reserves Coverage



The IIP position has also deteriorated, especially once equity liabilities are valued at market prices (Lane and Milesi-Ferretti, LMF).

Gross External Liabilities
(In percent of GDP)



Sources: CEIC Data Company; Bloomberg Data LP; IMF, updated and extended version of the Lane and Milesi-Ferretti (LMF) dataset; and IMF staff calculations.

Table 1. India: Millennium Development Goals, 1990–2011 1/

	1990	2004	2006	2008	2009	2010	2011
Eradicate extreme poverty and hunger 2/							
Income share held by lowest 20%	...	...	8.6	...	...	...	...
Malnutrition prevalence, weight for age (% of children under 5)	59.5	...	43.5	...	...	...	...
Poverty gap at $1.25 a day (PPP) (%)	...	...	10.5	...	...	7.5	...
Poverty headcount ratio at $1.25 a day (PPP) (% of population)	...	...	41.6	...	...	32.7	...
Poverty headcount ratio at national poverty line (% of population)	...	37.2	...	...	...	29.8	...
Prevalence of undernourishment (% of population)	...	...	...	19.0	...	...	...
Achieve universal primary education 3/							
Literacy rate, youth total (% of people ages 15-24)	61.9	...	81.1	...	...	...	...
Persistence to grade 5, total (% of cohort)	...	65.8	68.5	...	...	...	...
Primary completion rate, total (% of relevant age group)	...	84.1	86.7	95.7	...	...	...
School enrollment, primary (% net)	...	89.9	89.4	92.1	...	...	...
Promote gender equality 4/							
Proportion of seats held by women in national parliament (%)	5	9	8	9	11	11	11
Ratio of girls to boys in primary and secondary education (%)	...	90	90	95	...	...	...
Ratio of young literate females to males (% ages 15-24)	67	...	84	...	...	...	...
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	13	18	18	...	...	...	...
Reduce child mortality 5/							
Immunization, measles (% of children ages 12-23 months)	56	61	70	74	74	74	...
Mortality rate, infant (per 1,000 live births)	81	58	54	51	50	49	47
Mortality rate, under-5 (per 1,000)	114	77	72	68	66	63	61
Improved maternal health 6/							
Births attended by skilled health staff (% of total)	...	...	47	53	...	...	...
Maternal mortality ratio (modeled estimate, per 100,000 live births)	600	...	280	...	...	200	...
Combat HIV/AIDS, malaria, and other diseases 7/							
Contraceptive prevalence (% of women ages 15-49)	43	53	56	54	...	...	...
Incidence of tuberculosis (per 100,000 people)	216	212	205	196	190	185	...
Prevalence of HIV, female (% ages 15-24)	...	...	...	...	0.1	...	...
Prevalence of HIV, total (% of population ages 15-49)	0.1	0.4	0.4	0.3	0.3	...	...
Ensure environmental sustainability 8/							
CO2 emissions (metric tons per capita)	0.8	1.2	1.3	1.5	...	...	...
Forest area (% of land area)	21.5	...	22.8	...	...	23.0	...
GDP per unit of energy use (constant 2000 PPP $ per kg of oil equivalent)	3.3	4.4	4.9	5.1	5.0	0.0	...
Improved sanitation facilities (% of population with access)	18	29	31	32	33	34	...
Improved water source (% of population with access)	69	85	88	90	91	92	...
Develop a global partnership for development 9/							
Fixed line and mobile phone subscribers (per 100 people)	0.6	8.8	17.9	32.3	46.6	64.3	74.6
Internet users (per 100 people)	0.0	2.0	2.8	4.4	5.1	7.5	10.1
Total debt service (% of exports of goods, services and income)	34.9	14.5	8.6	9.6	6.0	5.6	...
Unemployment, youth female (% of female labor force ages 15-24)	...	10.8	10.8	...	...	...	...
Unemployment, youth male (% of male labor force ages 15-24)	...	10.4	10.4	...	...	...	...
Unemployment, youth total (% of total labor force ages 15-24)	...	10.5	10.5	...	...	...	...
General indicators							
Fertility rate, total (births per woman)	3.9	2.9	2.8	2.7	2.7	2.6	...
GNI per capita, Atlas method (current US$)	390.0	620.0	810.0	1,030.0	1,150.0	1,260.0	1,410.0
GNI, Atlas method (current US$) (billions)	341.0	698.0	941.0	1,230.0	1,390.0	1,540.0	1,750.0
Gross capital formation (% of GDP)	26.0	32.8	35.7	34.3	36.6	35.1	35.5
Life expectancy at birth, total (years)	58.4	63.0	63.7	64.4	64.8	65.1	...
Literacy rate, adult total (% of people ages 15 and above)	...	...	62.8	...	...	...	...
Population, total (millions)	874	1,120	1,160	1,190	1,210	1,220	1,240
Trade (% of GDP)	15.2	36.9	45.3	52.3	45.6	49.7	54.5

Source: World Bank, *World Development Indicators,* 2012.

1/ In some cases the data are for earlier or later years than those stated.

2/ Halve, between 1990 and 2015, the proportion of people whose income is less than 1.25 dollar a day.

3/ Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.

4/ Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.

5/ Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

6/ Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

7/ Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.

8/ Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.

9/ Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

Table 2. India: Selected Economic Indicators, 2008/09–2013/14 1/

I. Social Indicators

GDP (2011/12)		**Poverty (percent of population)**	
Nominal GDP (in billions of U.S. dollars):	1,848	Headcount ratio at $1.25 a day (2010):	32.7
GDP per capita (U.S. dollars):	1,526	Undernourished (2008):	19.0
Population characteristics (2011/12)		**Income distribution (2005, WDI)**	
Total (in billions):	1.2	Richest 10 percent of households:	28.3
Urban population (percent of total):	31	Poorest 20 percent of households:	8.6
Life expectancy at birth (years):	65	Gini index (2005):	33.4

II. Economic Indicators

	2008/09	2009/10	2010/11	2011/12 Prel.	2012/13 Proj.	2013/14 2/ Proj.
Growth (y/y percent change)						
Real GDP (at factor cost)	6.7	8.4	8.4	6.5	5.4	6.0
Real GDP (at market prices, calendar year)	6.2	4.9	10.4	7.9	4.5	5.9
Industrial production	2.5	5.3	8.2	2.9	...	...
Prices (y/y percent change, average)						
Wholesale prices (2004/05 weights)	8.1	3.8	9.6	8.9	7.9	7.5
Wholesale prices (2004/05 weights, end of period)	1.6	10.4	9.7	7.7	7.8	7.2
Consumer prices - industrial workers (2001 weights)	9.1	12.4	10.4	8.4	10.8	9.7
Saving and investment (percent of GDP)						
Gross saving 2/	32.0	33.8	32.4	31.3	31.1	31.8
Gross investment 2/	34.3	36.6	35.1	35.5	35.0	35.5
Fiscal position (percent of GDP) 3/						
Central government deficit	-7.8	-7.0	-6.5	-6.0	-5.8	-5.7
General government deficit	-10.0	-9.8	-9.5	-9.0	-8.7	-8.5
General government debt 4/	74.5	72.8	68.1	67.3	66.8	66.0
Money and credit (y/y percent change, end-period)						
Broad money	19.3	16.8	16.1	13.1	19.5	17.9
Credit to commercial sector 5/	16.9	15.8	21.3	17.1	15.5	...
Financial indicators (percent, end-period) 5/						
91-day treasury bill yield	5.0	4.4	7.3	9.0	8.1	...
10-year government bond yield	7.0	7.8	8.0	8.6	8.2	...
Stock market (y/y percent change, end-period)	-37.9	80.5	10.9	-10.5	4.5	...
External trade 6/						
Merchandise exports (in billions of U.S. dollars)	189.0	182.4	250.5	309.8	301.8	317.4
y/y percent change	13.7	-3.5	37.3	23.7	-2.6	5.2
Merchandise imports (in billions of U.S. dollars)	308.5	300.6	381.1	499.5	491.6	521.7
y/y percent change	19.8	-2.6	26.7	31.1	-1.6	6.1
Balance of payments (in billions of U.S. dollars)						
Current account balance	-27.9	-38.2	-45.9	-78.2	-78.0	-78.3
(In percent of GDP)	-2.3	-2.8	-2.7	-4.2	-3.9	-3.6
Foreign direct investment, net	22.4	18.0	9.4	22.1	10.9	21.1
Portfolio investment, net (equity and debt)	-14.0	32.4	30.3	17.2	30.4	23.9
Overall balance	-20.6	13.0	12.9	-13.1	-6.6	0.3
External indicators						
Gross reserves (in billions of U.S. dollars, end-period)	252.0	279.1	304.8	290.3	283.7	284.0
(In months of imports) 7/	8.4	7.2	6.3	6.1	5.7	5.3
External debt (in billions of U.S. dollars, end-period)	224.5	260.9	305.9	345.7	404.5	471.5
External debt (percent of GDP, end-period)	18.4	19.2	18.2	18.7	20.4	21.7
Of which : Short-term debt 8/	6.7	6.7	7.1	7.7	9.0	10.0
Ratio of gross reserves to short-term debt (end-period) 8/	3.1	3.1	2.6	2.0	1.6	1.3
Debt service ratio 9/	5.1	5.0	5.1	5.8	5.7	5.8
Real effective exchange rate						
(y/y percent change, period average for annual data)	-6.8	8.0	11.6	-3.4	...	...
Exchange rate (rupee/U.S. dollar, end-period) 5/	51.2	45.5	45.0	50.3	53.0	...

Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; Bloomberg L.P.; World Bank, *World Development Indicators* ; and IMF staff estimates and projections.

1/ Data are for April–March fiscal years.

2/ Differs from official data, calculated with gross investment and current account. Gross investment includes errors and omissions.

3/ Divestment and license auction proceeds treated as below-the-line financing. Subsidy related bond issuance classified as expenditure.

4/ Includes combined domestic liabilities of the center and the states, inclusive of MSS bonds, and external debt at year-end exchange rates.

5/ For 2012/13, as of October 2012.

6/ On balance of payments basis.

7/ Imports of goods and services projected over the following 12 months.

8/ Short-term debt on residual maturity basis, including estimated short-term NRI deposits on residual maturity basis.

9/ In percent of current account receipts, excluding grants.

Table 3. India: Balance of Payments, 2008/09–2013/14 1/

(In billions of U.S. dollars)

	2008/09	2009/10	2010/11	2011/12 Prel.	2012/13 Proj.	2013/14 Proj.
Current account balance	-27.9	-38.2	-45.9	-78.2	-78.0	-78.3
Merchandise trade balance	-123.2	-121.9	-129.9	-194.7	-189.9	-204.3
Merchandise exports	185.3	178.8	251.1	304.8	301.8	317.4
Merchandise imports	308.5	300.6	381.1	499.5	491.6	521.7
Oil	93.7	87.1	106.0	154.9	167.6	180.0
Non-oil	214.8	213.5	275.1	344.6	324.0	341.7
Non-factor services balance	53.9	36.0	48.8	64.1	67.4	80.7
Receipts	106.0	96.0	132.9	142.3	146.1	158.2
Of which : software services	46.3	49.7	55.5	62.2	…	…
Payments	52.0	60.0	84.1	78.2	78.7	77.4
Income, net	-7.1	-8.0	-17.3	-16.0	-24.7	-30.3
Transfers, net	44.8	52.0	53.1	63.5	69.2	75.6
Capital account balance	7.4	51.6	62.0	67.8	71.3	78.5
Direct investment, net	22.4	18.0	9.4	22.1	10.9	21.1
Portfolio investment, net	-14.0	32.4	30.3	17.2	30.4	23.9
Government borrowing, net	2.4	2.9	4.9	2.3	0.1	0.5
Commercial borrowing, net	7.9	2.0	12.5	10.3	6.4	4.9
Short-term credit, net	-2.0	7.6	11.0	6.7	12.3	15.7
NRI deposits, net	4.3	2.9	3.2	11.9	13.9	15.2
Other capital, net 2/	-13.6	-14.1	-9.3	-2.7	-2.7	-2.7
Errors and omissions	0.4	0.0	-3.0	-2.4	0.0	0.0
Overall balance	-20.1	13.4	13.1	-12.8	-6.6	0.3
Valuation changes 3/	-37.7	13.6	12.7	-1.6	0.0	0.0
Increase in gross reserve stock (including valuation changes)	57.7	-27.1	-25.8	14.5	6.6	-0.3
Memorandum items:						
Foreign exchange reserves	252.0	279.1	304.8	290.3	283.7	284.0
In months of next year's imports (goods and services)	8.4	7.2	6.3	6.1	5.7	5.3
Current account balance (percent of GDP)	-2.3	-2.8	-2.7	-4.2	-3.9	-3.6
Merchandise trade balance (percent of GDP)	-10.1	-9.0	-7.7	-10.5	-9.6	-9.4
Overall balance (percent of GDP)	-1.6	1.0	0.8	-0.7	-0.3	0.0

Sources: CEIC Data Company Ltd; and IMF staff estimates and projections.

1/ Data are for April-March fiscal years.

2/ Net other capital is sum of net banking capital (RBI format), rupee debt, and net other capital (RBI format) less net NRI deposits.

3/ Calculated as difference between the stock of reserves and the overall balance of BOP.

Table 4. India: Reserve Money and Monetary Survey, 2008/09–2012/13 1/

	2008/09	2009/10	2010/11	2011/12	2012/13		
					Jun	Sep	Oct
Reserve money	(In billions of rupees, end-period)						
Reserve money	9,880	11,557	13,768	14,272	14,638	14,489	14,627
Net domestic assets of RBI	-2,921	-763	483	-450	-1,320	-1,087	-1,393
Claims on government (net)	616	2,116	3,966	5,357	5,676	5,362	5,552
Center	618	2,116	3,940	5,344	5,672	5,356	…
States	-2	0	25	13	3	6	…
Claims on commercial sector	138	13	22	40	42	36	…
Claims on banks	104	12	52	49	72	166	…
Other items (net)	-3,779	-2,904	-3,556	-5,896	-7,109	-6,651	…
Net foreign assets of RBI	12,801	12,319	13,286	14,722	15,958	15,576	16,021
	(Contribution to reserve money growth)						
Reserve money	6.4	17.0	19.1	3.7	7.8	6.9	5.3
Net domestic assets of RBI	1.7	21.8	10.8	-6.8	-9.4	3.2	2.0
Claims on government (net)	18.8	15.2	16.0	10.1	14.1	13.2	11.5
Net foreign assets of RBI	4.7	-4.9	8.4	10.4	17.2	3.7	3.3
Monetary survey	(In billions of rupees, end-period)						
Broad money (M3)	47,948	56,027	65,041	73,592	77,449	77,994	79,003
Currency with public	6,655	7,675	9,118	10,265	10,715	10,638	10,655
Deposits	41,238	48,314	55,886	63,299	66,715	67,338	68,332
Non-bank deposits at RBI	56	38	37	28	19	17	16
Net domestic assets	34,426	43,212	51,108	58,154	60,982	61,909	62,982
Domestic credit	42,922	51,606	62,206	73,290	76,557	77,115	77,900
Net credit to government	12,773	16,692	19,839	23,696	25,310	25,844	26,137
Of which: RBI	616	2,116	3,966	5,357	5,676	5,362	5,552
Credit to commercial sector	30,149	34,914	42,367	49,594	51,247	51,271	51,763
Of which: commercial bank lending	27,755	32,448	39,421	46,119	47,630	48,853	48,159
Nonfood	27,293	31,963	38,778	45,306	46,555	47,920	47,207
Other items (net)	-8,496	-8,394	-11,098	-15,136	-15,575	-15,206	-14,918
Net foreign assets	13,522	12,815	13,933	15,438	16,467	16,085	16,021
	(Twelve-month percent change)						
Broad money (M3)	19.3	16.8	16.1	13.1	15.6	13.4	13.1
Net domestic assets	26.4	25.5	18.3	13.8	15.2	16.2	17.0
Domestic credit	23.4	20.2	20.5	17.8	20.0	17.4	16.7
Net credit to government	42.0	30.7	18.9	19.4	22.2	20.1	19.1
Credit to commercial sector	16.9	15.8	21.3	17.1	18.9	16.1	15.5
Of which: commercial bank lending	17.5	16.9	21.5	17.0	18.6	15.7	14.0
Nonfood	17.8	17.1	21.3	16.8	18.3	15.4	13.7
Net foreign assets	4.4	-5.2	8.7	10.8	17.3	3.5	0.0

Sources: CEIC Data Company Ltd.; IMF International Financial Statistics; and Fund staff calculations.

1/ Data are for April–March fiscal years.

Table 5. Central Government Operations, 2008/09–2013/14 1/

	2008/09	2009/10	2010/11	2011/12 Est.	2012/13 Proj.	2013/14 Proj.
	(In percent of GDP)					
Revenue	**9.9**	**9.2**	**9.2**	**8.9**	**8.7**	**9.0**
Taxes	7.9	7.1	7.5	7.1	7.3	7.5
Income tax	5.7	5.8	5.8	5.6	5.4	5.6
Excise tax	1.9	1.6	1.8	1.7	1.8	1.9
Customs duties	1.8	1.3	1.8	1.7	1.8	1.8
Other taxes	0.3	0.0	0.0	0.0	0.0	0.0
Less: States' share	2.8	2.6	2.9	2.9	3.0	3.0
Grants	0.0	0.0	0.0	0.0	0.0	0.0
Other revenue 2/	1.9	2.0	1.7	1.7	1.4	1.4
Property income	1.1	1.1	0.9	0.8	0.7	0.7
Sale of goods and services	0.3	0.3	0.3	0.3	0.2	0.2
Miscellaneous and unidentified revenue	0.6	0.6	0.5	0.6	0.5	0.5
Expenditure	**17.7**	**16.2**	**15.7**	**14.9**	**14.5**	**14.7**
Expense 3/	**15.1**	**14.6**	**13.9**	**13.3**	**12.7**	**12.9**
Compensation of employees 4/	1.3	1.5	1.2	1.1	1.1	1.1
Interest	3.4	3.3	3.0	3.1	3.2	3.1
Subsidies 5/	2.9	2.2	2.1	2.4	1.9	2.1
Food	0.8	0.9	0.8	0.8	0.7	0.8
Fertilizer	1.7	0.9	0.8	0.8	0.7	0.6
Petroluem	0.4	0.4	0.5	0.8	0.4	0.6
Grants	2.2	2.2	2.0	1.9	2.0	2.0
Other expense 6/	5.3	5.4	5.5	4.8	4.6	4.6
Net acquisition of nonfinancial assets	**2.6**	**1.6**	**1.8**	**1.6**	**1.8**	**1.8**
Net acquisitions of nonfinancial assets 7/	2.6	1.6	1.8	1.6	1.8	1.8
Gross Operating Balance	-5.2	-5.4	-4.7	-4.4	-4.0	-3.9
Net lending / borrowing (overall balance)	**-7.8**	**-7.0**	**-6.5**	**-6.0**	**-5.8**	**-5.7**
Net financial transactions	-7.8	-7.0	-6.5	-6.0	-5.8	-4.8
Net acquisition of financial assets	0.0	-0.7	-1.9	-0.2	-0.3	-0.5
Domestic	0.0	-0.7	-1.9	-0.2	-0.3	-0.5
Currency and deposits	-0.1	-0.5	-0.3	-0.1	-0.1	-0.1
Loans	0.1	0.1	0.2	0.0	0.1	0.0
Share and other equity	0.0	-0.4	-1.7	-0.2	-0.3	-0.4
Net incurrence of liabilities	7.8	6.3	4.7	5.8	5.5	4.3
Domestic	7.6	6.1	4.4	5.7	5.4	4.2
Debt securities 8/	5.1	6.2	4.2	5.5	5.3	4.2
Other accounts payable	2.5	-0.1	0.1	0.2	0.1	0.0
Foreign	0.2	0.2	0.3	0.1	0.1	0.1
Loans	0.2	0.2	0.3	0.1	0.1	0.1
Memorandum items:						
Balance under authorities' definition	-6.0	-6.5	-4.9	-5.8	-5.6	-5.3
Primary balance	-4.4	-3.7	-3.5	-2.9	-2.7	-2.6
Central government debt 9/	58.6	56.5	52.9	52.1	51.2	48.5

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

1/ Data for April - March fiscal years

2/ In 2007/08, includes a special dividend payment from the RBI amounting to 0.7 precent of GFP. The authorities include this item under "other capital receipts" rather than non-tax revenue. In 2010/11 excludes 3G receipts, classified under sale of nonfinancial assets.

3/ Includes the surcharge on Union duties transferred to the National Calamity Contingency Fund.

4/ Pensions are included under expense not otherwise classified.

5/ Includes subsidy-related bond issuance.

6/ Other expense includes purchases of goods and services.

7/ In 2007/08, includes roughly 0.7 percent og GDP for the government's purchase of SBI shares from the RBI.

8/ Debt securities include bonds and short-term bills, as well as loans.

9/ External debt measured at historical exchange rates. Inclusive of MSS bonds.

Table 6. General Government Operations, 2008/09–2013/14 1/

	2008/09	2009/10	2010/11	2011/12 Est.	2012/13 Proj.	2013/14 Proj.
			(In percent of GDP)			
Revenue	**19.7**	**18.6**	**19.1**	**18.6**	**18.4**	**18.7**
Taxes	16.5	15.3	16.3	15.8	15.9	16.2
Grants	0.0	0.0	0.0	0.0	0.0	0.0
Other revenue	3.2	3.2	2.8	2.7	2.5	2.5
Expenditure	**29.7**	**28.4**	**28.7**	**27.6**	**27.1**	**27.2**
Expense	24.8	24.6	24.7	23.7	23.1	23.4
of which: interest	5.0	4.9	4.6	4.4	4.5	4.4
Net acquisition of nonfinancial assets	4.9	3.8	4.0	3.9	4.0	3.8
Gross Operating Balance	-5.0	-6.0	-5.5	-5.1	-4.7	-4.7
Net lending (+)/borrowing (–) (fiscal balance)	**-10.0**	**-9.8**	**-9.5**	**-9.0**	**-8.7**	**-8.5**
Net financial worth, transactions	-10.0	-9.8	-9.5	-9.0	-8.7	-9.4
Net acquisition of financial assets	0.7	0.0	-1.1	0.3	0.1	-0.5
Domestic	0.7	0.0	-1.1	0.3	0.1	-0.5
Currency and deposits	0.2	-0.1	0.0	0.2	0.2	-0.1
Loans	0.3	0.5	0.6	0.2	0.3	0.0
Equity and investment fund shares	0.3	-0.4	-1.7	-0.2	-0.3	-0.4
Net incurrence of liabilities	**10.7**	**9.8**	**8.4**	**9.2**	**8.9**	**8.9**
Domestic	7.6	6.1	4.4	5.7	5.4	4.2
Debt securities	7.2	7.9	5.6	7.0	6.9	7.0
Other accounts payable	3.3	1.7	2.5	2.1	1.9	1.8
Foreign	0.2	0.2	0.3	0.1	0.1	0.1
Loans	0.2	0.2	0.3	0.1	0.1	0.1
Memorandum items:						
Primary balance	-4.9	-4.9	-4.9	-4.6	-4.2	-4.1
Nondefence capital expenditure	4.2	3.0	3.2	3.1	3.3	3.0
State and union territory governments' balance 2/	-2.1	-2.8	-3.0	-3.0	-2.9	-2.8
General government debt 3/	74.5	72.8	68.1	67.3	66.8	65.9

Sources: Data provided by the Indian authorities; state level data from the RBI Study on State Finances; and Fund staff amalgamate and prepare projections.
1/ The consolidated general government comprises the central government (CG) and state governments. Data for April-March fiscal year.
2/ The authorities treat states' divestment proceeds, including land sales, above-the-line as miscellaneous capital receipts. Staff definition treats divestment receipts as a below-the-line financing item.
3/ Includes combined domestic liabilities of CG and states governments, inclusive of MSS bonds, and sovereign external debt at year-end exchange rates.

Table 7. India: Macroeconomic Framework, 2008/09–2016/17 1/

				Prel.	Projections				
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Growth (percent change)									
Real GDP (at factor cost)	6.7	8.4	8.4	6.5	5.4	6.0	6.5	6.8	6.9
Non-agricultural sector	8.1	9.8	8.6	7.1	6.0	6.6	7.1	7.4	7.5
Prices (percent change, period average)									
Wholesale prices (2004/05 =100)	8.1	3.8	9.6	8.9	7.9	7.5	7.1	6.5	5.7
Consumer prices	9.1	12.4	10.4	8.4	10.8	9.7	8.8	8.0	6.8
Saving and investment (percent of GDP)									
Gross saving 2/	32.0	33.8	32.4	31.3	31.1	31.8	32.6	33.3	33.8
Gross investment 3/	34.3	36.6	35.1	35.5	35.0	35.5	35.9	36.2	36.5
Fiscal position (percent of GDP)									
Central government balance 4/	-7.8	-7.0	-6.5	-6.0	-5.8	-5.7	-5.5	-5.3	-5.1
General government balance 4/	-10.0	-9.8	-9.5	-9.0	-8.7	-8.5	-8.4	-8.1	-7.8
General government debt 5/	74.5	72.8	68.1	67.3	66.8	66.0	64.9	63.1	61.3
External trade (percent change, BOP basis)									
Merchandise exports (in U.S. dollar terms)	13.7	-3.5	40.5	21.4	-2.6	5.2	5.6	8.1	8.4
Merchandise imports (in U.S. dollar terms)	21.2	-5.0	28.2	32.2	-1.6	6.1	6.9	7.8	8.8
Balance of payments (in billions of U.S. dollars)									
Current account balance	-27.9	-38.2	-45.9	-78.2	-78.0	-78.3	-78.2	-78.7	-80.6
(in percent of GDP)	-2.3	-2.8	-2.7	-4.2	-3.9	-3.6	-3.3	-3.0	-2.7
Foreign direct investment, net	22.4	18.0	9.4	22.1	10.9	21.1	23.2	25.8	28.8
Portfolio investment, net (equity and debt)	-14.0	32.4	30.3	17.2	30.4	23.9	26.3	29.2	32.7
Overall balance	-20.1	13.4	13.1	-12.8	-6.6	0.3	6.8	14.6	22.4
External indicators									
Gross reserves (in billions of U.S. dollars, end-period)	252.0	279.1	304.8	294.4	283.7	284.0	290.8	305.4	327.9
(in months of imports) 6/	8.4	7.2	6.3	6.1	5.7	5.3	5.0	4.8	4.8
External debt (in billions of U.S. dollars, end-period)	224.5	260.9	305.9	345.7	404.5	471.5	543.1	620.7	705.3
External debt (percent of GDP, end-period)	18.4	19.2	18.2	18.7	20.4	21.7	22.7	23.4	23.7
Of which : short-term debt 7/	6.7	6.7	7.1	7.7	9.0	10.0	11.1	11.9	12.6
Ratio of gross reserves to short-term debt (end-period) 7/	3.1	3.1	2.6	2.1	1.6	1.3	1.1	1.0	0.9
Debt service (percent of current account receipts)	5.1	5.0	5.1	5.8	5.7	5.8	5.7	6.2	5.9

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

1/ Data are for April-March fiscal years unless otherwise mentioned. Calendar year data in 2008/09 column indicate data for 2008, for instance.
2/ Differs from official data, calculated with gross investment and current account.
3/ Statistical discrepancy adjusted.
4/ Divestment and license auction proceeds are treated as financing; includes subsidy related bond issuance.
5/ Includes combined domestic liabilities of the center and the states, inclusive of MSS bonds, and sovereign external debt at year-end exchange rates.
6/ Imports of goods and services projected over the following twelve months.
authority's definition.

Table 8. India: Indicators of External Vulnerability, 2008/09–2012/13 1/

	2008/09	2009/10	2010/11	2011/12	2012/13	2/
Financial indicators						
General government debt (percent of GDP)	74.5	72.8	68.1	67.3	66.8	(Projection)
Broad money (percent change, 12-month basis)	19.3	16.8	16.1	13.1	13.1	(October 2012)
Private sector credit (percent change, 12-month basis)	16.9	15.8	21.3	17.1	15.5	(October 2012)
91 day T-bill yield (percent; end-period)	5.0	4.4	7.3	9.0	8.1	(October 2012)
91 day T-bill yield (real, percent; end-period) 3/	-2.9	0.5	-2.1	0.1	1.9	(October 2012)
External indicators						
Exports (percent change, 12-month basis in US$) 4/ 5/	13.7	-3.5	37.3	23.7	-2.6	(Projection)
Export volume (percent change, 12-month basis) 5/	7.3	-2.7	27.2	9.2	0.4	(Projection)
Imports (percent change, 12-month basis in US$) 4/ 5/	19.8	-2.6	26.7	31.1	-1.6	(Projection)
Import volume (percent change, 12-month basis) 5/	8.5	6.9	16.2	9.5	-1.0	(Projection)
Terms of trade (percent change, 12 month basis) 5/	-0.3	3.7	-2.5	-4.8	-1.1	(Projection)
Current account balance (percent of GDP)	-2.3	-2.8	-2.7	-4.2	-3.9	(Projection)
Capital and financial account balance (percent of GDP)	0.6	3.8	3.7	3.7	3.6	(Projection)
Of which: Net portfolio investment (debt and equity)	-1.1	2.4	1.8	0.9	1.5	(Projection)
Other investment (loans, trade credits, etc.)	-0.1	0.1	1.3	1.5	1.5	(Projection)
Net foreign direct investment	1.8	1.3	0.6	1.2	0.6	(Projection)
Foreign currency reserves (billions of US$)	252.0	279.1	304.8	290.3	283.7	(Projection)
Official reserves (in months of imports of goods and services)	8.4	7.2	6.3	6.1	5.7	(Projection)
Ratio of foreign currency reserves to broad money (percent)	26.9	22.7	21.1	20.1	20.6	(September 2012)
Total short-term external debt to reserves (percent) 6/	32.4	32.5	39.2	48.9	62.9	(Projection)
Total external debt (percent of GDP)	18.4	19.2	18.2	18.7	20.4	(Projection)
Of which: public sector debt	4.8	4.5	3.9	3.7	3.4	(Projection)
Total external debt to exports of goods and services (percent)	76.1	93.7	79.8	76.5	90.3	(Projection)
External interest payments to exports of goods and services (percent)	2.9	2.3	1.9	2.3	1.7	(Projection)
External amortization payments to exports of goods and services (percent)	12.5	15.2	12.9	13.8	16.3	(Projection)
Exchange rate (per US$, period average)	46.0	47.4	45.6	47.9	53.1	(October 2012)
REER (y/y change in percent; end-period)	-4.0	18.4	2.3	-3.7	0.4	(October 2012)
Financial market indicators						
Stock market index (end-period)	9709	17528	19445	17404	18505	(October 2012)
Foreign currency debt rating						
Moody's Investor Services	Baa2	Baa3	Baa3	Baa3	Baa3	(September 2012)
Standard and Poor's 7/	BBB-	BBB-	BBB-	BBB-	BBB-	(September 2012)
Fitch Ratings 7/	BBB-	BBB-	BBB-	BBB-	BBB-	(September 2012)

Sources: Data provided by the Indian authorities; Bloomberg L.P.; CEIC Data Company Ltd.; IMF, *Information Notice System* and staff estimates and projections.

1/ Data for April-March fiscal years.

2/ Latest date available or staff estimate, as noted.

3/ Equals nominal yield minus actual WPI core inflation.

4/ Data from 2009/10 are on a customs basis, whereas data for previous years are on a BOP basis.

5/ Terms of trade including goods and services. Goods volumes are derived from partner country trade price deflators, and services volumes are derived using U.S. CPI from the WEO database.

6/ Including short-term debt on contracted maturity basis, all NRI deposits, and medium and long-term debt on residual maturity basis, different from authorities' definition.

7/ On negative outlook.

Table 9. India: Financial Soundness Indicators, 2005/06–2011/12

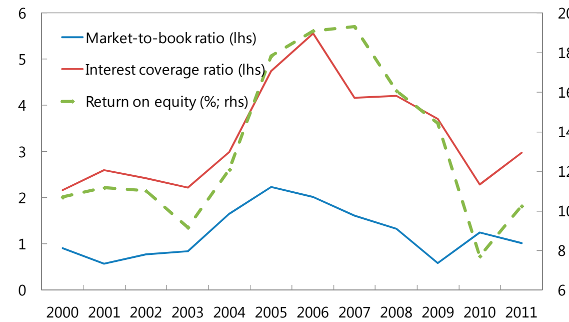
	2008/09	2009/10	2010/11	2011/12	2012/13 Q1
Measures of financial strength and performance 1/					
Risk-weighted capital adequacy ratio (CAR) 2/	13.2	13.6	14.2	14.2	13.7
Public sector banks	12.3	12.1	13.1	13.2	12.8
Old Private Sector Banks	14.3	13.8	14.6	14.1	13.8
New Private Sector Banks	15.1	17.3	16.9	16.7	16.1
Foreign banks	15.0	18.1	17.0	16.7	15.7
Number of institutions not meeting 9 percent CAR	0	1	0	0	...
Public sector banks	0	0	0	0	...
Old Private Sector Banks	0	1	0	0	...
New Private Sector Banks	0	0	0	0	...
Foreign banks	0	0	0	0	...
Net nonperforming loans (percent of outstanding net loans)	1.1	1.1	1.1	1.4	1.5
Public sector banks	0.9	1.1	1.2	1.7	1.8
Old Private Sector Banks	0.9	0.8	0.5	0.6	0.6
New Private Sector Banks	1.4	1.1	0.6	0.5	0.5
Foreign banks	1.8	1.8	0.6	0.6	0.8
Gross nonperforming loans (percent of outstanding loans)	2.3	2.4	2.4	3.1	3.3
Public sector banks	2.0	2.2	2.3	3.3	3.6
Old Private Sector Banks	2.4	2.3	2.3	1.8	1.9
New Private Sector Banks	3.1	2.9	2.6	2.2	2.2
Foreign banks	3.8	4.3	2.5	2.6	2.9
Restructured Loans (percent of outstanding advances)	2.7	4.2	3.5	4.7	...
Public sector banks	3.0	5.1	4.3	5.9	...
Old Private Sector Banks	-	3.6	3.0	3.5	...
New Private Sector Banks	-	1.7	0.7	1.1	...
Foreign banks	0.7	0.5	0.2	0.1	...
Net profit (+)/loss (-) of commercial banks 4/	1.0	1.1	1.1	1.1	...
Public sector banks	0.9	1.0	1.0	0.9	...
Old Private Sector Banks	1.0	1.0	1.1	1.2	...
New Private Sector Banks	1.1	1.4	1.5	1.6	...
Foreign banks	1.7	1.3	1.8	1.8	...
Balance sheet structure of all scheduled banks					
Loan/deposit ratio	73.9	73.6	76.5	78.6	...
Investment in government securities/deposit ratio	28.7	28.8	26.0	27.0	...
Lending to sensitive sectors (in percent of loans and advances)					
Real estate	17.5	16.6	16.6	15.7	...
Capital market	1.8	1.9	1.8	1.7	...
Commodities	0.0	0.0	0.0	0.0	...

Sources: Annual Report and Report On Trend and Progress of Banking in India, Reserve Bank of India; Banksco
Speech on Corporate Restructuring by Dr. K. C. Chakrabarty at the Corporate Debt Restructuring.
Conference in Mumbai, 8/11/2012.

1/ Some loan classification and provisioning standards do not meet international standards.
2/ Unitl 2009/10 Based on Basel I; subsequently, Basel II is are used. The Basel II CAR exceeded the Basel I CAR
3/ Gross nonperforming loans less provisions.
4/ In percent of total assets.

ANNEX I. VULNERABILITIES OF INDIA'S CORPORATE SECTOR

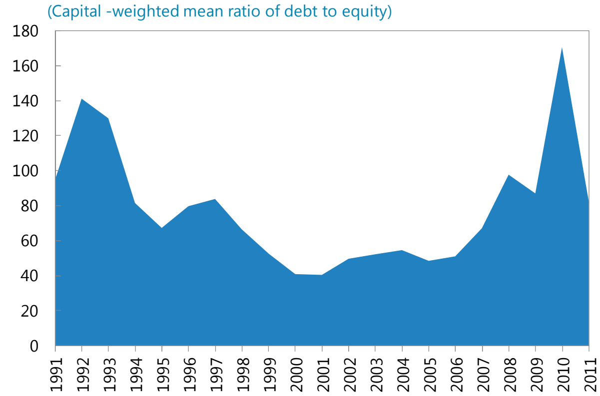
Median Market-to-Book & Interest Coverage Ratio, and Return on Equity of Non-financial Indian Corporations



1. Indian nonfinancial corporates' health strengthened markedly before the GFC. After a period of significant corporate restructuring in the early 2000s, Indian corporates deleveraged their balance sheets and improved their debt servicing capacity as profitability rose, particularly in the last few years before the crisis. Although domestic bank credit and external debt grew rapidly before the GFC, equity increased even more. Between 2001 and 2006, the market-to-book ratio of Indian corporates more than tripled, and the ICR more than doubled. Corporate India's return on equity almost doubled over the same period.

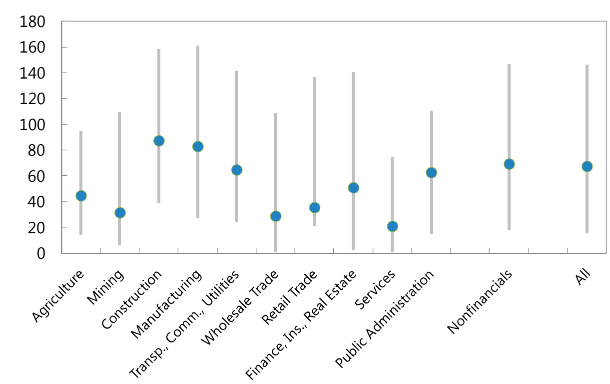
Leverage Ratio for Indian Nonfinancial Corporates

(Capital -weighted mean ratio of debt to equity)



Leverage Ratios by Sector

(Ratio of Debt to Equity. Median , 25th and 75th percentiles by sector)

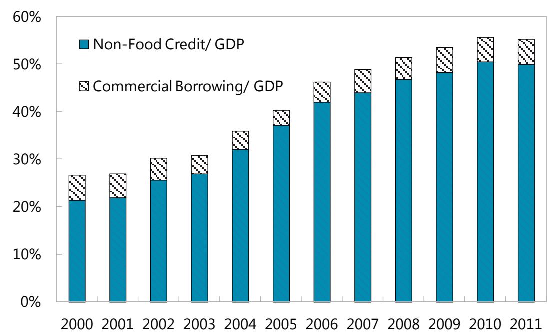


2. During the current slowdown, however, various indicators of corporate health have deteriorated, especially leverage. Domestic credit to corporates continued to rise rapidly during and even after the GFC, driven by public banks' loans, especially for infrastructure projects. In addition, ECB has risen by 48 percent in the past two years. As the equity market saw little issuance after the GFC and stock price performance has for long periods been lackluster, corporate leverage rose. The (capital-weighted) mean ratio of debt to equity for Indian nonfinancial companies increased from 40 percent in 2001 to 83 percent in 2011. Indian corporates are now among the most leveraged among EM peers. Finally, overall leverage measures disguise substantial differences across sectors: manufacturing and construction, where infrastructure and power lending are concentrated, display significantly higher ratios.

3. External corporate funding creates the potential for feedback loops between corporate vulnerabilities and external shocks. Corporates rely on foreign sources for around one-fifth of their financing, including ECB, FDI, and trade credits. Not only has foreign financing grown, but ECB is also concentrated, with about a sixth of approved foreign loans going to only 14 large conglomerates. BIS data show that nearly two-thirds of India's liabilities to BIS reporting banks are borne by nonbank companies, and these loans are for the most part cross-border and predominantly short-term. In addition, debt service over the next two years is forecast at higher levels than during the GFC, and the maturity profile has steepened. Data limitations prevent a full-fledged analysis of FX risk borne by corporates and about a fifth of ECBs are FII holdings of domestic corporate bonds, which are in rupees. However, the RBI estimates that up to 65 percent of FX borrowing of Indian corporations is unhedged, though this does not take into account natural hedges.

Corporate Borrowing

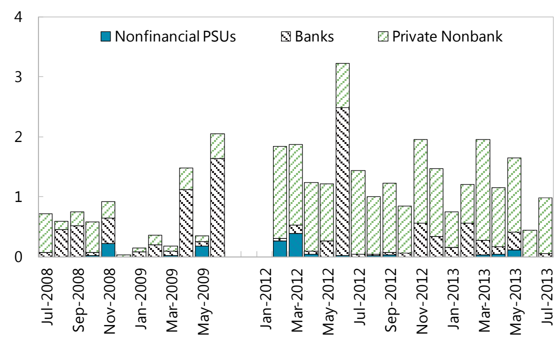
(In percent of GPD)



Sources: CEIC Data Company

Debt Payments

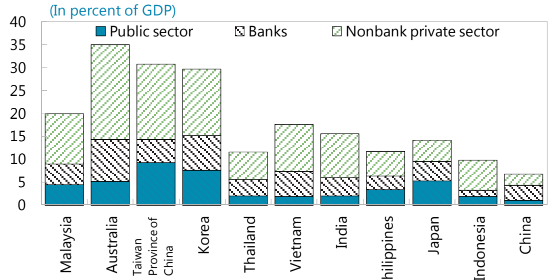
(In billions of US$)



Source: Dealogic and IMF staff estimates.

BIS Reporting Banks' Foreign Claims on Selected Asian Economies by Sector 1/

(In percent of GDP)

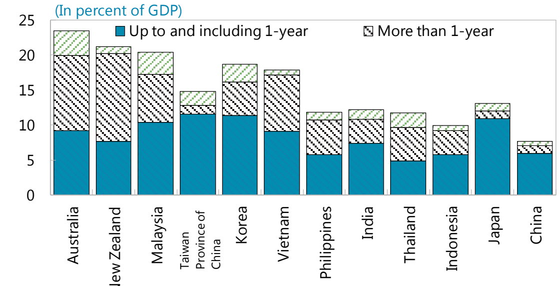


Sources: Bank for International Settlements (BIS); CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.

1/ Claims are on ultimate risk basis. Uses annual 2011 GDP in the denominator. Not all economies have data available for euro area banks.

BIS Reporting Banks' International Claims on Selected Asian Economies by Maturity 1/

(In percent of GDP)

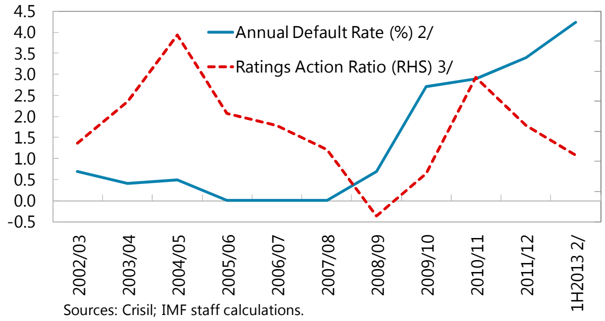


Sources: Bank for International Settlements (BIS); CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.

11/ Claims are on immediate borrower basis. Uses annual 2011 GDP in U.S. dollar in the denominator.

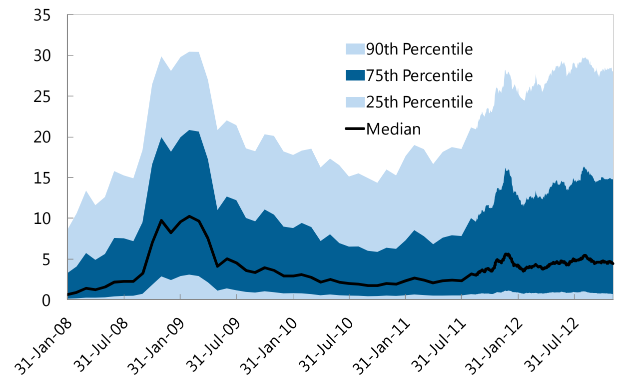
4. **Credit rating actions have reflected the deterioration in the corporate outlook, as have market-based indicators of credit risk.** Credit rating agencies' downgrades have exceeded upgrades and the annual default rate of companies has increased. Default probabilities as estimated by Moody's KMV have also begun to rise. Notably, although the KMV default probability for the median firm remains below the levels reached during the GFC, the probability for the 90th percentile is at similar levels, pointing to significant stress at the tail of the corporate distribution.

With Defaults Increasing, Credit Downgrades are Outpacing Upgrades 1/



Sources: Crisil; IMF staff calculations.
1/ The universe of rated firms increased significantly in recent years, possibly skewing the results.
2/ 1st half 2012 default rate is annualized.
3/ Number of upgrades for the year divided by the number of downgrades.

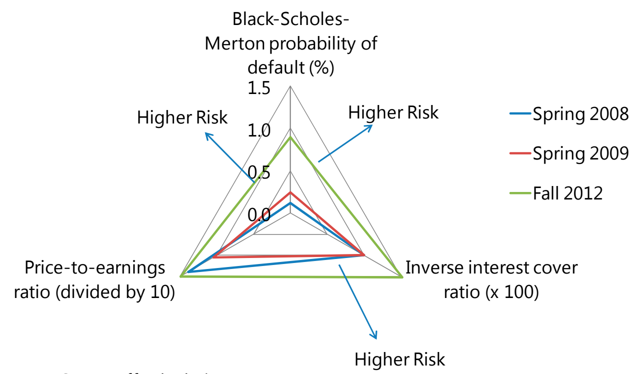
Expected Default Frequencies for Indian Corporates
(In percent)



5. Some important corporate indicators have deteriorated beyond values experienced during the GFC. Declining profitability during the recent slowdown has brought the earnings of Indian corporations to the same level relative to equity prices they were at before the GFC, suggesting risk of stock price declines. The ability to cover interest payments has also worsened, with ICRs now generally worse than during the GFC.

6. The share of troubled companies has become significant. The table below shows the share of corporate borrowing accounted for by companies exhibiting relatively extreme values of four indicators of corporate health. The percentage of debt owed by loss-making firms has reached 16.6 percent. Nearly one-sixth of the borrowing by Indian corporates is accounted for by companies whose total debt exceeds five times equity.

Corporate Vulnerability Indicators 1/



Sources: CVU; staff calculations.
1/ Outward movement of a triangle indicates greater risk exposure.

Interest Cover, Profitability, Liquidity and Leverage for Major Indian Non-Financial Corporates
(Share of firms below/above critical values)

	ICR (<1) 1/	Profitability (<0) 2/	Liquidity (<0.5) 3/	Leverage (>5) 4/
		(percent of firms in sample)		
1999/00	16.1	22.5	6.3	32.2
2000/01	16.3	23.8	7.2	41.3
2001/02	16.4	25.2	7.6	42.5
2002/03	14.8	21.1	9.6	40.4
2003/04	10.2	15.0	7.7	23.6
2004/05	8.2	10.8	6.7	9.3
20015/06	5.9	7.0	6.3	5.2
2006/07	5.0	7.7	6.3	6.1
2007/08	4.8	8.8	8.0	6.9
2008/09	10.6	14.3	8.3	23.2
2009/10	6.3	10.4	7.9	7.8
2010/11	7.1	11.5	7.7	9.4
2011/12	11.0	16.6	8.4	15.8

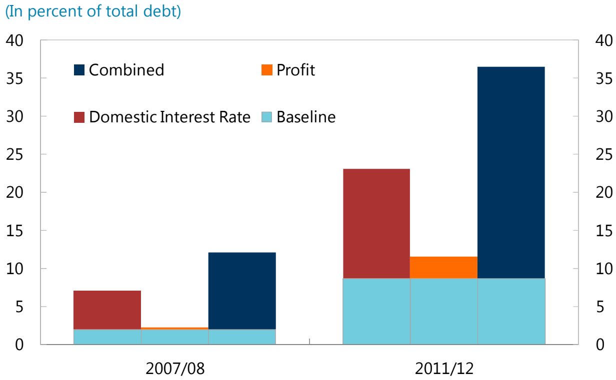
Sources: CMIE Prowess; IMF staff calcuations. Sample size about 900 firms.
Note: Critical values are shown in parentheses.
1/ EBITDA / Interest expenses.
2/ Profit after tax / Sales.
3/ 'Current Ratio' = Current assets / Current liabilities.
4/ Total debt / Market capitalization.

Stress-Test Results for the Non-Financial Corporate Sector (2012)

Baseline March 2012	Domestic Interest Rate Shock	Profits	Combined
	+1000 bps	-25 percent	
Share of debt of companies with ICR <1 in total corporate sector debt			
8.71	23.12	11.62	36.51
Share of the number of companies with ICR <1 in total number of companies			
10.97	21.54	14.93	30.34

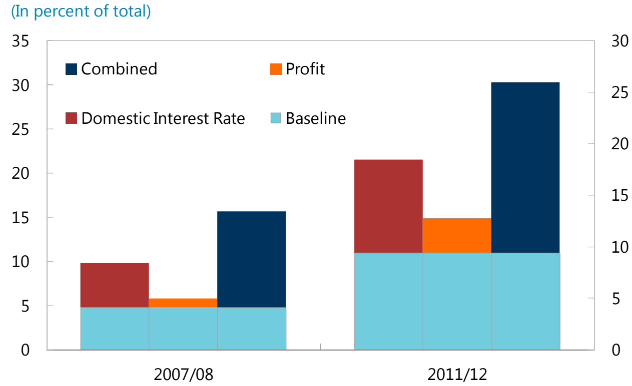
7. A shock to interest rates similar to the GFC would likely have a more severe impact today. During the GFC, the tightening of global liquidity led to severe strain in Indian money markets. Today a increase of 10 percentage points in interest rates faced by Indian corporates—a shock consistent with the rise in Indian short-term rates during the GFC—would also lead to significant stress. The number of companies with ICRs below one would double. These companies are generally highly leveraged, and as they would account for almost one-fourth of corporate sector debt, the exposure of the financial system would be high. Combining this shock with a 25 percent decline in operating profits –again comparable to the GFC - would raise the share of debt held by companies with ICR below one to 37 percent. Not only is the share of corporates with ICR below one greater today than during 2008/09, but the increases in corporate stress in response to the shocks analyzed above are also greater now, indicating a more vulnerable corporate universe than four years ago. At the time of the GFC, several companies also reported losses on their FX exposure. Although data limitations prevent an analysis of an FX shock and complex FX derivatives are currently less common than before the GFC, reports still indicate a significant share of unhedged FX exposures, which would exacerbate corporate stress.

Share of Debt of Companies with ICR <1
(In percent of total debt)



Source: CMIE Prowess; IMF staff calculations.

Share of Companies with ICR <1
(In percent of total)



Source: CMIE Prowess; IMF staff calculations.

ANNEX II. FISCAL CONSOLIDATION IN INDIA: OPTIONS AND STRATEGIES[1]

1. **Fiscal consolidation in India remains a key policy priority.** The consolidation of the early 2000s under the Fiscal Responsibility and Budget Management Act (FRBMA) has not been repeated, as weak revenue and ongoing spending pressures have kept deficits high. The decline in public debt has slowed, and its continued downward trajectory is vulnerable to slower growth. High debt and deficits constrain space for countercyclical policy and absorption of contingent liabilities. While borrowing costs are contained via the Statutory Liquidity Ratio and other measures, high deficits can crowd out investment. Recently, the government has endorsed a medium-term roadmap for deficit reduction, but with the forthcoming 12th Plan aiming to raise spending for health, infrastructure and education, expenditure will have to be reoriented within this shrinking envelope.

2. **This study explores options for India's fiscal consolidation.** It uses the micro-founded DSGE approach of the IMF's multi-region Global Integrated Monetary and Fiscal (GIMF) model (see Berkmen 2011).[2] The key features of the model are discussed in Kumhof *et al.* (2010).[3] A three-region setup is used, namely India, the euro area and the rest of the world. Results are gauged relative to the steady state, calibrated on India's medium-term outlook. Government consumption is the largest component of spending, and consumption taxes are the principal source of revenue.

3. **Three consolidation scenarios are assessed.** Each scenario reduces the deficit to the steady state level in 5 years, the timeframe of the 13th Finance Commission and the period the current consolidation roadmap is expected to take to reach its target.[4] The scenarios assume containment of government spending, comprehensive subsidy reform, and GST implementation. Subsidy reform is modeled as a reduction in untargeted transfers and GST implementation as stronger consumption tax collection. The three scenarios achieve the same deficit objective with different combinations of the three instruments.

India: Consolidation Scenarios
(Change in % of GDP)

	Scenario I	Scenario II	Scenario III
Instruments	Baseline	Investment-friendly	Investment & social-friendly
Gvt. Consumption	-2%	-3%	-3%
Gvt. investment		2%	1%
Transfers	-2%	-2%	-2%
Transfers LIQs			1%
Consumption tax	-1%	-2%	-2%
Total consolidation	-5%	-5%	-5%

[1] Based on a forthcoming IMF working paper by Jules S. Tapsoba.

[2] IMF Working Paper 11/13.

[3] IMF Working Paper 10/34.

[4] This target is illustrative because the relationship between the size of the adjustment and the size of the response is approximately linear.

- *Neutral consolidation:* The neutral case cuts government consumption by 2 percent of GDP, scales down untargeted transfers (namely through subsidy reform) by 2 percent of GDP, and improves consumption tax efficiency by 1 percent of GDP.

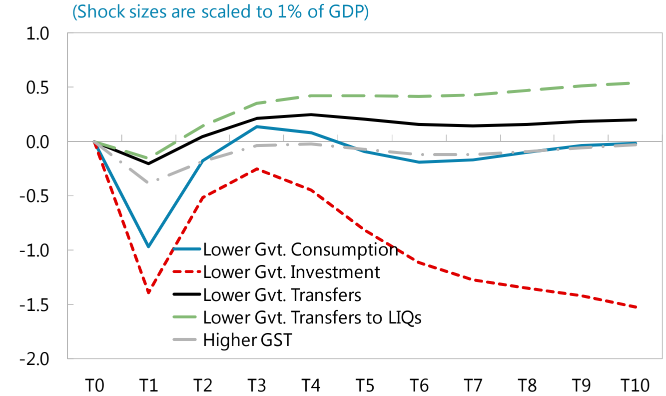
- *Investment-friendly consolidation:* The investment-friendly case cuts government consumption by an additional 1 percent of GDP, raises the consumption tax take by 1 percent of GDP, reorienting the savings towards public investment.

- *Social- and investment-friendly consolidation:* The third case assumes the same pattern of consolidation as the "investment-friendly consolidation" scenario. However, the 2 percent of GDP in additional savings from the consolidation measures are applied equally to public investment and, via transfers to liquidity-constrained individuals, to the social safety net.

4. **Overall, cutting untargeted transfers is the most growth friendly tool, while lower investment is the most damaging.** For all instruments a standardized shock of 1 percent of GDP is assumed. The multiplier for each year is obtained as the change in real GDP resulting from the shock. In year 1, the multipliers for government consumption and investment are the highest, 1 and 1½ respectively; that is, a 1 percent cut in government consumption of investment brings down GDP by an almost equal amount. Transfers, on the other hand, produce smaller multipliers of only around 0.2. These results broadly corroborate recent RBI analytical work[1]. The multiplier for the consumption tax is estimated at 0.4 (Figure 1). However, over the long run, the dynamics become more complicated and vary across scenarios.

Figure 1. India: Growth Effect of Fiscal Consolidation by Instrument

(Shock sizes are scaled to 1% of GDP)

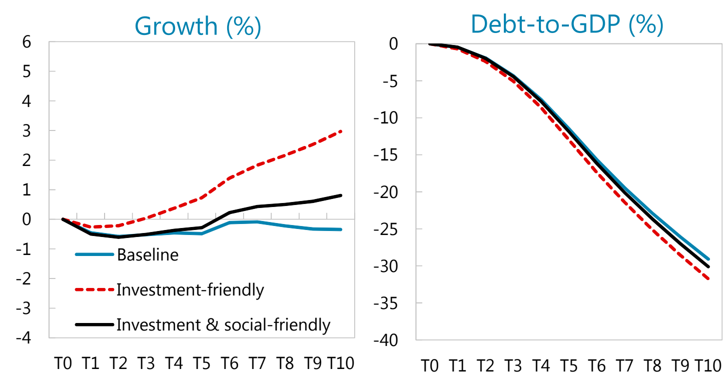


Source: Author's simulations.

5. **Reorientation toward investment spending minimizes short-tem negative growth effects, while supporting faster growth later.** Under a trajectory where the deficit falls by 1 percent a year, all three scenarios lower debt by almost 30 percent of

Figure 2. India: Gradual Fiscal Consolidation

(Deviation from steady state)



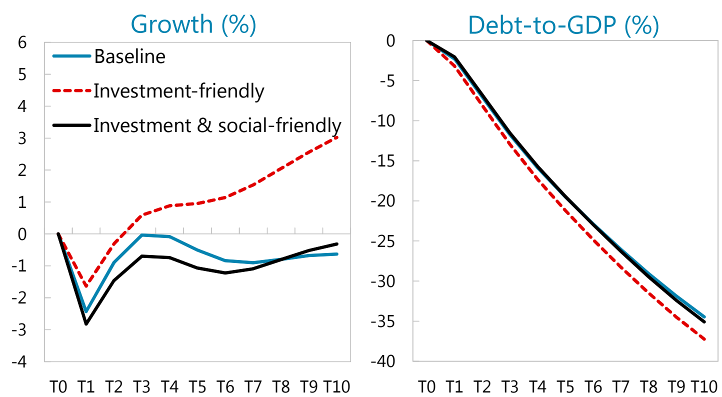
Source: Author's simulations.

[1] R. Jain and P. Kumar, "Size of Government Expenditure Multipliers in India: A Structural VAR Analysis," forthcoming RBI Working Paper.

GDP relative to the steady state over a 10-year horizon (Figure 2). Growth rates fall below the baseline by less than 1 percent relative to the steady state in the short run as the supply-side investment response is significantly less than the immediate aggregate demand effect. Under the neutral case, output does not recover from this shock, as the adverse impacts of government consumption cuts and consumption tax hikes accumulate. But in the investment-friendly case, output bounces back after three years, and GDP growth is at almost 3 percent higher than the steady state in year 10.[5] Finally, output recovers more slowly in the social-friendly case, though still at a faster pace than under the neutral consolidation.

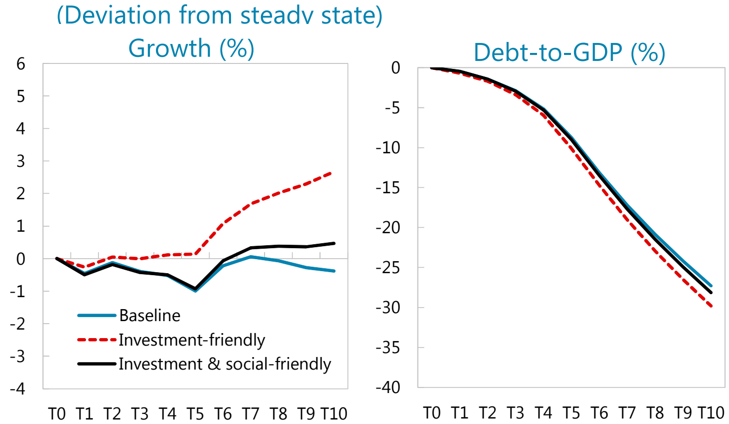
6. The pace of consolidation is also important. The growth effect of stopping consolidation and then having to backload it later can be large. Compared to a consolidation which stops and then restarts, a frontloaded consolidation rapidly stabilizes the debt ratio. A frontloaded austerity plan pares debt ratios by an additional 5 percent of GDP compared to a uniform consolidation, though at a short-run output cost of 1½–3 percent of GDP (Figure 3), with output recovering in the medium term only under the investment-friendly scenario. On the other hand, delaying consolidation from Year 2 to Year 5 undermines debt reduction and postpones the longer-term growth rebound by two–three years (Figure 4). As before, the investment and social-based adjustments attenuate short-term losses and support stronger longer-run recovery.

Figure 3. India: Frontloaded Fiscal Consolidation
(Deviation from steady state)



Source: Author's simulations.

Figure 4. India: Stop-and Go Fiscal Consolidation
(Deviation from steady state)



Source: Author's simulations.

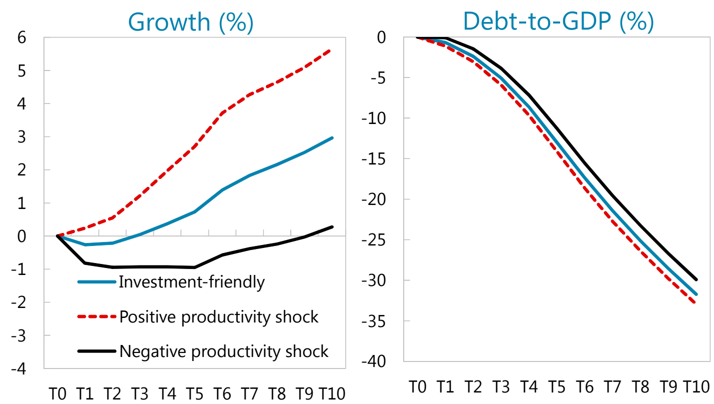
7. Continued structural reforms would ease fiscal consolidation. Structural reforms that raise productivity—such as increasing labor market flexibility, enhancing infrastructure, or attracting FDI— also support fiscal consolidation by strengthening growth. Under a scenario in which a productivity shock (specifically a 0.15 percent increase in labor-augmenting productivity for five years in both tradable and nontradable intermediate goods sectors), debt and growth outcomes are

[5] In the GIMF, public investment permanently raises infrastructure stock, which enters the production function of final goods and increases the productivity of private capital.

better than under a baseline without reform.[6] Analogously, if productivity is shocked negatively, as would be the case if reform momentum is reversed, growth is notably lower.

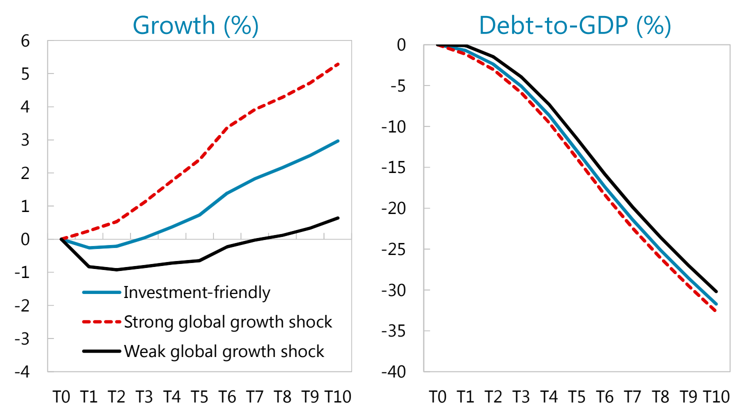
8. Finally, global conditions can facilitate or complicate fiscal adjustment. India is an increasingly open economy and is affected by shocks emanating from the rest of the world. To account for these risks, upside and downside scenarios in the global economy are added to fiscal consolidation. As previously, in all regions in the model, labor-augmenting productivity is positively shocked (negatively for the downside scenario) by 0.15 percent per year for 5 years in all production sectors. Global conditions have little effect on the debt path, but growth is stronger (Figure 6). With high global growth, short-term output costs do not occur, but under a global recession, the negative growth effects in India associated with consolidation would be prolonged.

Figure 5. India:Fiscal Consolidation and Structural Reforms
(Deviation from steady state)



Source: Author's simulations.

Figure 6. India: Fiscal Consolidation and Inward Spillovers
(Deviation from steady state)



Source: Author's simulations.

9. This presents several lessons for designing a durable consolidation. First, the potential long-term benefits of fiscal consolidation are considerable despite the short-term costs. Rationalizing subsidies and improving revenues will be key to a successful adjustment. Furthermore, the most growth-friendly consolidation would require reorienting at least part of the savings towards public investment. Well-targeted social programs for needy households can also help attenuate the near-term pain from austerity. Policy experiments also show that a consistent deficit reduction path, anchoring expectations through a credible plan, and pursuing accompanying structural reforms to improve productivity can all also make consolidation significantly more growth-friendly.

[6] These effects are cumulative: productivity will be 0.75 percent higher indefinitely in both sectors after the fifth year.

ANNEX III. SUBSIDY REFORM IN INDIA[1]

1. India is a net importer of crude oil, and its oil industry features heavy public involvement. India is the fourth largest global consumer of fuel products. Consumption of fuel products increased by around 17 percent between 2006 and 2011, and stagnant domestic crude production has resulted in increasing crude imports by refineries. The upstream sector (the extraction of crude oil and natural gas) and downstream sector (refining and the selling of natural gas and petroleum products) both feature significant state involvement. Reliance Industries Ltd (RIL) is the only private sector company present at all levels.

- ***Crude Oil.*** Two state-owned companies—Oil and Natural Gas Corporation Ltd (ONGC) and Oil India Ltd (OIL)—account for just over 75 percent of all extracted crude oil, with ONGC alone accounting for nearly 65 percent. For natural gas, the share of private and joint-venture companies has increased substantially in recent years, reaching over half of total production by 2010.

- ***Refining.*** The main public sector refining companies are Indian Oil Corp Ltd (IOC), Bharat Petroleum Corp Ltd. (BPCL), and Hindustan Petroleum Corp Ltd (HPCL). With output refined by private firms increasing significantly since 2009, refining is now roughly equally divided between the public and private refineries.

- ***Distribution.*** To foster competition, in the mid-2000s the government authorized other upstream and refining companies,[2] both public and private, to distribute fuel products to domestic consumers in competition with the three public sector refining companies (IOC, BPCL and HPCL). However the largest oil marketing companies (OMCs), IOC, BPCL, and HPCL still dominate the marketing side, controlling over 80 percent of the market.

2. Some fuel prices in India are centrally administered, which has resulted in large price subsidies for these products. Diesel prices are set centrally, with variations for transportation and tax differences across the country. The prices of kerosene (distributed through the Public Distribution System) and LPG (distributed through a network of private distributors) are also set centrally, though in both cases there are some sales to non-eligible persons and businesses at market rates. With administered prices not keeping pace with higher crude oil prices, these subsidies have risen in recent years. OMCs are compensated for these losses through annual payments, and the financing of these losses is shared between upstream oil producers and the central government according to a formula negotiated annually.

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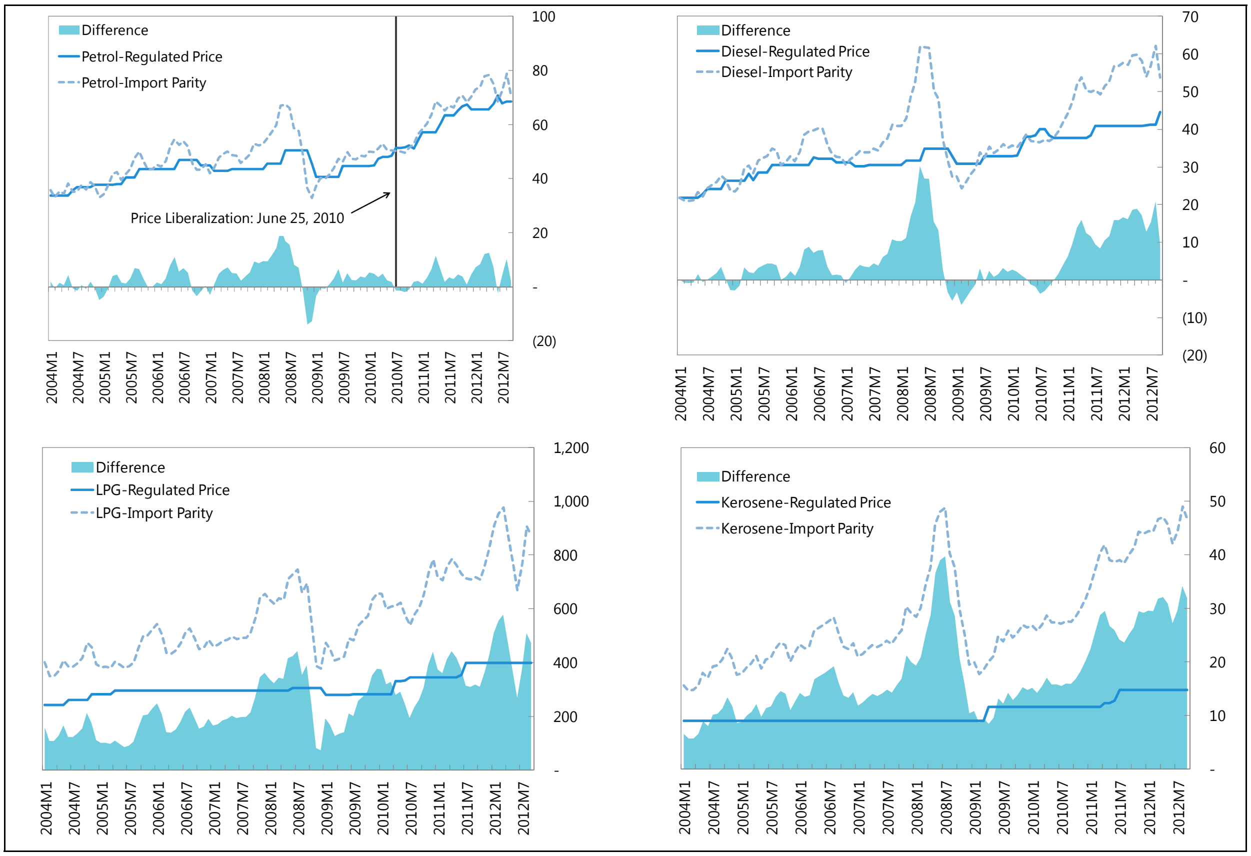
[1] Based on a forthcoming IMF working paper by Adil Mohommad, Rahul Anand, David Coady, Vimal Thakoor, and James P. Walsh.

[2] Including: ONGC; GAIL; Mangalore Refinery and Petrochemicals Ltd (MRPL); Numaligarh Refinery Ltd (NRL); RIL; Essar Oil Limited (EOL); and Shell India Pvt. Ltd (SIMPL).

3. The fiscal cost of incomplete pass-through of international price increases has been high, with underpricing significantly greater for LPG and kerosene than for diesel and gasoline. Total subsidies rose from 0.7 percent of GDP in 2004/5 to 2.1 percent in 2008/9, and in 2011/12 were over 1.9 percent of GDP. The degree to which regulated fuel prices in India fall below market prices can be approximated by estimating how much fuel would cost if it were imported.[3] The figure below shows market parity and Delhi retail prices for diesel, LPG and kerosene, as well as the difference between the two. Petrol, liberalized in 2010, is also shown for comparison purposes. Until the liberalization of petrol in 2010, both diesel and petrol prices tended to move more closely with market prices than LPG and kerosene, where underpricing has been significantly greater.



[3] Given that India also exports many fuel products, a measure of export parity could also be considered. However given that India is a net importer of petroleum products, import parity is also appropriate, and in any case, this approach matches closely how the government of India calculates the underpricing of fuels. The formula used here incorporates the freight-inclusive cost of comparable products refined in Singapore, adjusts for retailing margins and for central government taxes as well as New Delhi taxes, and is comparable to the prices published on the website of the Indian Oil Corporation.

Underpricing of Petroleum Derivatives and Total Cost of Subsidies 1/

Fuel	Import Parity Price	Regulated Price	Difference	Pct. Of Reg. Price	Consumption	Total Subsidy
		(in rupees per liter)			(mill. tons)	(billion Rs)
Diesel	56.5	47.0	9.5	20.2	66.1	995
LPG	905.9	394.3	511.6	129.8	14.5	386
Kerosene	46.6	14.8	31.7	214.0	8.8	332
Gasoline	72.7	68.1	4.7	6.8	16.0	73

1/ As defined by import parity formula and as of 10/2012.
Source: IMF staff calculations.

4. However, with diesel accounting for a larger share of consumption of fuels, total subsidies for diesel exceed those for LPG and kerosene. Total diesel sales, most of which are for commercial purposes rather than for household consumption, are almost twice the combined gasoline, LPG and kerosene sales[4]. Diesel prices (as of end-October-2012) were 20 percent below import parity, while LPG and kerosene registered less than half of import parity. Given higher volumes, diesel thus accounted for slightly more than half of the total estimated subsidy bill. However, its smaller underpricing means that diesel price hikes, such as those taken in September 2012, have a larger effect on the total subsidy bill than those to LPG and kerosene.

Share of Fuels in Fuel Expenditure

	Decile 1	Decile 2	Decile 3	Decile 4	Decile 5	Decile 6	Decile 7	Decile 8	Decile 9	Decile 10
Diesel	0.6	0.3	0.3	1.3	0.7	1.1	1.7	1.6	2.3	4.9
Petrol	4.4	6.8	16.1	18.2	27.9	33.1	38.4	41.6	49.1	63.9
LPG	6.0	11.6	18.8	26.6	32.7	37.5	39.5	43.0	40.3	28.8
Kerosene	89.0	81.2	64.9	53.9	38.7	28.3	20.4	13.8	8.2	2.3

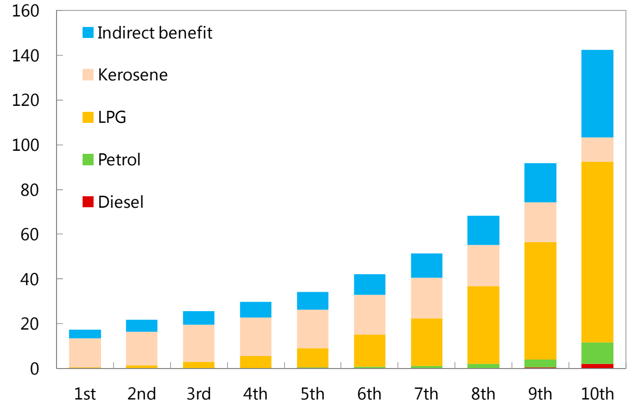
Source: NSSO, 66th Round consumption expenditure survey, and staff calculations.

5. The use of petroleum products differs with income. Poorer Indians use kerosene for lighting and some for cooking, while richer households use electricity and LPG, respectively: the share of kerosene in direct fuel consumption by households drops from nearly 90 percent for the poorest group to just 2 percent for the richest. Expenditure on fuels by high-income Indians is greatly weighted toward gasoline, which accounts for almost 2/3 of the fuel budget of the top decile of households. LPG consumption also rises with income, but tapers off among higher-income groups.

[4] Recently, however, the liberalization of gasoline prices has led to increased purchases of diesel-power cars, changing the balance somewhat.

6. Subsidies are thus poorly targeted, with most of the benefits accruing to higher income households. The rupee benefit enjoyed directly through consumption of subsidized fuels by the richest decile of households is more than 7 times that enjoyed by the poorest decile, nearly 45 percent higher than the total benefits enjoyed by bottom 40 percent of the population, and 40 percent higher than those enjoyed by the next richest decile. Similarly, the indirect benefits through distorted prices of other goods and services disproportionately benefit the top 10 percent of the population; more than 10 times the indirect benefits of the lowest decile, 75 percent higher than the total benefit of the bottom 40 percent of the population, and more than double the benefits enjoyed by the next richest decile.

Benefits from Subsidies by Decile
(In Rupees per capita per month)



7. Raising fuel prices to import-parity levels would have significant direct and indirect effects on inflation. The direct effect of higher prices for fuel products comes from their share in the baskets of the WPI (4.7 percent for diesel) and CPI (3.3 percent for all petroleum fuels). Raising all prices to market levels would raise the CPI by 3.4 percent, and the WPI by 4.2 percent. However, higher costs for fuels, especially for diesel, would have ramifications for other goods and services. These indirect effects of higher fuels can be estimated using a Leontief inverse matrix. The largest impact would be felt in manufacturing and services industries, but inflationary effects would also be significant in construction and even food. Overall, the total direct and indirect effects of higher fuel prices are 4.4 percent for consumer prices and 5.5 percent for the WPI.

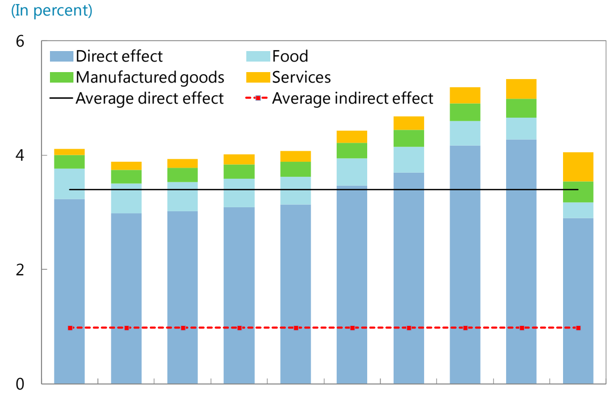
Impact on Price Indices of Fuel Price Change
(In percent)

	Direct Impact	Total Impact
CPI 1/	3.4	4.4
WPI 2/	4.2	5.5

1/ CPI calculation is based on average increase in cost of living across expenditure deciles due to raising prices of diesel, petrol, kerosene, and LPG to import parity levels, as well as the indirect inflationary impact on prices of other goods and services consumed by households.
2/ WPI calculation is based on direct impact of raising prices of diesel, petrol, kerosene, and LPG to import parity levels, as well as indirect effects from higher input costs resulting from raising diesel prices only.

8. The effect of higher fuel prices on the cost of living varies little across income deciles. As the initial increase in prices passes through the economy, the average indirect effect on household welfare is estimated around 0.9–1.1 percent and is more or less neutral across the distribution. The indirect effect can be broken down to food, manufactured goods, and services. As expenditure increases, the impact due to higher prices of food diminishes from 60 percent of the total indirect impact to less than 25 percent for the highest decile,

Cost of Living Impact on Households
(In percent)



while that due to the price of manufactured goods and services increases correspondingly. As second-round effects take root, the overall cost of living is estimated to increase by between 4.3–4.5 percent, exhibiting a moderately progressive pattern barring at the extremes, most noticeably for the highest expenditure group.

9. **International experience provides useful lessons for promoting public support for fuel subsidy reforms.** Reform should be preceded by a public information campaign highlighting that subsidies are fiscally costly, that the benefits are regressive and accrue mostly to higher income groups, and that they crowd-out higher priority public spending (e.g., on education, health, social protection, and public infrastructure). A clear reform plan should be developed and communicated to the public, identifying a clear timeline for eliminating subsidies and key public expenditures that will be financed by the resulting fiscal space. This plan should also specify measures to mitigate the adverse impact of price increases on consumers, in particular lower-income households.

10. **Where subsidy reform involves large increases in fuel prices, these should be implemented gradually to allow consumers to improve their energy efficiency and thus mitigate the adverse impact of future rounds of price increases.** Gradual reform also helps reduce the impact on inflation. The reform can be sequenced by concentrating initial price increases on fuel products that are less important for lower income households (e.g., diesel and LPG) and more gradually increasing the prices of fuels that are more important for lower income households (e.g., kerosene). This also allows time to strengthen the social safety net to protect households from price increases, including through better targeting of fuel subsidies. Gradual reform can be achieved through the adoption of an automatic pricing mechanism that adjusts retail prices according to a predetermined schedule, but limits the magnitude of any single price increase.

11. **Similar reform strategies were used in a number of countries that have successfully eliminated fuel subsidies and undertaken broader energy sector reforms.** In the late 1990s, to generate public support, both the Philippines and Turkey undertook extensive public information campaigns setting out the motivation for energy sector reform, including energy price deregulation. They both adopted an automatic pricing mechanism prior to the full liberalization of fuel prices in the late 1990s and early 2000s. Prices were increased gradually over subsequent years and targeted social safety net programs were scaled up to mitigate the adverse impact on lower income households. South Africa has consistently applied an automatic pricing mechanism for fuel products for a number of decades, with the objective of attracting private sector suppliers to the market by ensuring import costs were fully passed through to consumers thus avoiding the accumulation of subsidies. Brazil started sequentially deregulating the pricing for key fuel products in the mid-1990s. Gasoline pricing was deregulated in 1996, LPG in 1998, and diesel in 2001. After the withdrawal of LPG subsidies in 2001, the government introduced a new targeted LPG subsidy based on giving LPG vouchers to low-income households. It also introduced a large targeted cash transfer program to protect households from general price shock.

12. **While recent measures have helped address short-term fiscal pressures, a comprehensive medium-term reform strategy needs to be developed.** Gasoline prices were

liberalized in 2010. At the same time the government announced that diesel prices were also liberalized in principle, yet diesel subsidies persist. However, recent increases in diesel prices have helped to contain the increase in diesel subsidies and a 20 percent increase in regulated pump prices would eliminate the subsidy completely. Quantity limits have been imposed for subsidized LPG consumption starting from September 2012. A more comprehensive medium-term reform strategy should set out plans for continued decreases in subsidies, their replacement with better targeted subsidies, and the eventual liberalization of fuel prices.

13. A medium-term reform plan should be built on recent recommendations for subsidy reform. The 2011 Nilekani Interim Report of the Task Force on Direct Transfer of Subsidies on Kerosene, LPG and Fertilizer suggested that replacing subsidies with cash transfers delivered directly to households could substantially reduce their fiscal cost by eliminating the leakage that exists under the current system through beneficiaries receiving multiple benefits (duplication) or benefits for non-existent family members (ghost beneficiaries). Such a reform requires an effective mechanism for identifying beneficiaries and delivering transfers. In this regard, the ongoing nationwide rollout of India's Unique Identification (UID) program, which will result in the biometric identification of all Indians in the next few years, is extremely promising. The 2012 Kelkar Report of the Committee on Roadmap for Fiscal Consolidation recommended the broad use of UID to overhaul subsidies, and set out a timeline for the elimination of diesel and LPG subsidies over a period of three years and the reduction of more politically sensitive kerosene subsidies by one-third over the same period. A number of pilot subsidy reform programs have started been implemented in selected districts and the lessons from these pilots should be quickly incorporated into a carefully planned and communicated reform strategy.

ANNEX IV. INDIA: UPDATE ON THE FSAP'S MAIN RECOMMENDATIONS[1, 2]

Recommendations	Priority (H/M) & Time Frame (S/M)	Progress
Addressing System-wide Risks		
Enhance RBI monitoring of corporate indebtedness, refinancing risk, and foreign exchange exposures.	H/S	**Some progress.** Banks were directed to enhance monitoring of corporates credit, derivatives, and FX risk, and to exchange information about them. Supervisors will have the ability to penalize banks if they do not comply, but it is not clear how.
Improve the performance and financial strength of public financial institutions and subject them to full supervision and regulation.	H/M	**No change.** RBI indicated that the public banks are appropriately supervised. Public banks will be supervised within the general framework.
Financial Sector Oversight		
Strengthen oversight of banks' overseas operations through (MOUs) with host countries, onsite inspections, and supervisory colleges. **(BCP 25)**	H/M	**Notable progress.** Several MOUs have been signed, more are being negotiated, including UK, Bahrain, Hong Kong, and others. Overseas' offices of Indian banks representing 59% of total overseas assets have been inspected so far.
Enhance formal statutory basis for the autonomy of regulators in carrying out their regulatory and supervisory functions.	M/M	**Limited progress.** Discussions among different regulatory agencies have started within the framework of the Financial Stability and Development Council. More importantly, the proposals embedded in the Financial Sector Legislative Reforms Commission's Approach Paper (October 2012) envision a complete revamping of India's financial supervisory and regulatory

[1] As of November 8, 2012.

[2] For details, see the February 22, 2012 FSSA.

		architecture. This proposal would result in greater independence of these functions from other responsibilities of the RBI.
Tighten the definition of large and related party concentration (short-term) and reduce exposure limits to align them with international practices.	H/M	**Some progress.** Banks were instructed to record and supervise those transactions better, and to have limits in place. Otherwise, the RBI wants to wait until the Large Exposure Group of the Basel Committee has provided more guidance. In practice, each bank has its own definition of related parties, though, making it hard for supervisors to evaluate extent of bank exposures to large groups consistently, and evaluate systemic impact.
Enhance specialized expertise available to the supervision function by developing programs to accredit and retain skilled supervisors.	H/M	**Work in progress.**
Continue to strengthen coordination and information sharing mechanisms among domestic supervisors via MOUs and formal frameworks	H/S	**Some progress.** Financial Stability and Development Council to facilitate co-ordination among regulatory agencies was set up in 2010. A sub-committee headed by the RBI Governor focuses on inter-regulatory issues. Long-term, the suggestions in the Financial Sector Legislative Reforms Commission's Approach Paper would address this recommendation.
Provide a lead supervisor with legal backing for conducting consolidated supervision with authority to inspect subsidiaries and affiliates. (¶49)	H/S	**Some initial progress.** An addition to the banking law has been proposed to allow baking supervisors to inspect companies associated with any bank.
Expedite passage of Insurance Law (Amendment) Bill. (¶43)	H/S	**No change.**
Implement corrective action ladder for insurers (¶45)	H/S	**No change.**
Enact legislation formalizing the New Pension Scheme and the Pension Fund Regulatory and Development Authority. (¶33)	H/S	**No change.**
Plan for the reduction in the SLR and review the use of the hold-to-maturity category, incorporating changing global liquidity requirements. (¶51)	H/M	**Some progress.** The SLR was lowered to 23 percent in July 2012, but banks can keep 25 percent of their net demand and time liabilities in GSecs, without having to mark them to market. Authorities want to wait until further guidance with regards to Basel

		III LCR and NSFR is available before undertaking major changes.
Strengthen resolution tools by granting stronger powers to supervisors to resolve nonviable entities in an orderly fashion. (¶53)	H/M	**Work in progress.** This is in the planning stage.
Develop and periodically test arrangements to deal with a major disruption to the financial system. (¶54, 66) **(BCP 24)**	H/M	**Work in progress.** This is in the planning stage.
Broadening Markets and Services		
Ease investment directives and limits to encourage investments in corporate and infrastructure bonds by institutional investors. (¶34, 62)	M/M	**Partial progress.** Some easing of fixed-income investment limits for domestic institutional investors is being considered.
Consider further easing of restrictions on bond market investments by foreign institutional investors (FIIs). (¶59)	M/M	**Some progress.** Limits on FII investments in debt securities were increased and some restrictions eased.
Financial Markets Infrastructure		
Require CCPs to strengthen their liquidity risk management procedures to enable them to better cover losses in the event of a member's failure. (¶66)	H/M	**No change.**
Consider replacing the commercial bank settlement model for corporate securities and derivatives with a central bank settlement model. (¶66)	M/M	**No change.**
Enact comprehensive modern corporate insolvency law and upgrade SARFAESI and other existing laws governing insolvencies. (¶69)	M/M	**No change.** New company bill, which would improve the insolvency framework, is in parliament, but has not been passed.

INTERNATIONAL MONETARY FUND

INDIA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

December 21, 2012

Prepared By | Asia and Pacific Department

CONTENTS

ANNEX I. FUND RELATIONS

(As of November 30, 2012)

I. **Membership Status**:

Joined December 27, 1945; Article VIII.

II. **General Resources Account**

	SDR Million	% Quota
Quota	5,821.50	100.00
Fund Holdings of Currency	3,985.34	68.46
Reserve Tranche Position	1,836.35	31.54
Lending to the Fund		
New Arrangements to Borrow	1,021.50	

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	3,978.26	100.00
Holdings	2,886.38	72.55

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

V. **Financial Arrangements**:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	10/31/91	06/30/93	1,656.00	1,656.00
Stand-By	01/18/91	04/17/91	551.93	551.93
EFF	11/9/81	05/01/84	5,000.00	3,900.00

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

	Forthcoming				
	2012	2013	2014	2015	2016
Principal					
Charges/interest		0.91	0.92	0.92	0.92
Total		0.91	0.92	0.92	0.92

VII. **Exchange Rate Arrangement**:

As per the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER), the exchange rate in India is classified as floating. The exchange rate of the rupee is determined in the interbank market, where the Reserve Bank of India (RBI) intervenes at times. The RBI's role is to modulate excessive volatility so as to maintain orderly conditions. On August 20, 1994, India accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement. India maintains the following restrictions on the making of payments and transfers for current international transactions, which are subject to Fund approval under Article VIII, Section 2(a): restrictions related to the nontransferability of balances under the India-Russia debt agreement; restrictions arising from unsettled balances under inoperative bilateral payments arrangements with two Eastern European countries; and a restriction on the transfer of amortization payments on loans by non-resident relatives. The Executive Board has not approved these restrictions.

VIII. **Article IV Consultation**:

The previous Article IV consultation discussions were held in January 2012. The staff report (IMF Country Report No. 12/96) was discussed by the Executive Board on March 9, 2012.

IX. **FSAP Participation and ROSCs**:

FSSA/FSAP report was issued in January 2001; a fiscal transparency ROSC was issued in February 2001 (http://www.imf.org/external/np/rosc/ind/fiscal.htm); the data model of the ROSC (Country Report No. 04/96) was issued in April 2004. The missions for the second FSAP took place in 2011, and the concluding meetings were held in Delhi and Mumbai in January 2012.

X. **Technical Assistance**:

Dept	**Purpose**	**Date of Delivery**
FAD	Public expenditure management (follow-up)	5/96
MAE	Government securities market (follow-up)	7/96
STA	SDDS and statistics	12/96
STA	Balance of payments statistics	12/97
STA	SDDS and statistics	2/98
FAD	State level fiscal database and debt register	11/04
FAD	Pilot study on public private partnerships	12/04
STA	Balance of payments statistics	9/05
LEG	AML/CFT	5/08
LEG	AML/CFT	10/08

XI. **Outreach and Other Activities**:

Dept	Purpose	Date of Delivery
APD	Book: *India: Managing Financial Integration and Growth*	6/08
APD	Seminar: "Have We Seen this Movie Before? Comparing The Crisis of 2008 with East Asia 1998", presented at ICRIER/IM-Welt conference and Yale Initiative on Asian and International Relations	11/08
APD	Seminar: "Forecasting Growth and Inflation: China and India", presented in New Delhi	10/09
APD	Seminars: "What are the Effects of Fiscal Policy Shocks in India?" and "The global Financial Crisis: Explaining cross-country differences in the output impact", presented at the 6th NIPFP-DEA Research Conference, New Delhi	03/10
APD	Seminars: "Revisiting the Inflation-Output Trade-Off in India" and "Corporate Investment in India," presented at the Madras School of Economics.	01/12
APD	Op-ed: India Can Revive Investment in Live Mint	05/12
APD	Presentation: India—Outlook and Current Policy Issues, presented in Mumbai	05/12
APD	Interview: Global Economy to Improve in H2CY13: IMF's Laura Papi on CNBC	05/12
APD	Presentation: India—Outlook and Current Policy Issues, presented in New Delhi	05/12
APD	Interview: How the European Crisis will Affect India on Business Insider	05/12
APD	Op-ed: A Silver Lining in India's Slowdown in Business Standard website	05/21
APD	Blog: Guest Post—What can India do About Growth in Financial Times	06/12
APD	Session: Trade and Investment Climate in India in Washington, D.C.	06/12
APD	Op-ed: Inflation and Inequality—A Different Take on Food Prices in Live Mint	07/12
APD	Article: What's Behind India's Investment Weakness on State Bank of India website	07/12
APD	Op-ed: Global Uncertainty Highlights—The Need for a Cautious Approach to India's Macroeconomic Policy in Economic Times	10/12

XII. **Resident Representative**:

A resident representative's office was opened in November 1991. Mr. Thomas Richardson has been the Senior Resident Representative since August 2012.

ANNEX II. RELATIONS WITH THE WORLD BANK GROUP

In Bank FY12 (July 1, 2011–June 30, 2012), IBRD/IDA lending in India totaled US$3.18 billion. IFC committed US$960 million in FY12. The World Bank Group's (WBG) Country Strategy (CAS) for India for 2009–2012 focuses on helping India to fast-track the development of much-needed infrastructure and to support the low-income and special category states in achieving higher standards of living for their people. The strategy envisaged a total proposed IBRD lending program of US$11.6 billion for the four-year CAS period; in response to the financial crisis, the CAS envelope was widened by approximately US$3 billion in additional IBRD financing. Midway through the CAS implementation, the projected IBRD lending was revised upward to US$16 billion. India's FY12–14 IDA 16 allocation is SDR 3,348.3 billion (US$5,309 billion equivalent). India is IFC's second-largest country exposure in terms of disbursed and outstanding portfolio with commitments totaling US$4.2 billion for IFC's own account and US$558 million for the account of participants (as of October 31, 2012).

In response to the financial crisis as well as increased Government demand for the Bank Group's support, the pace of IBRD lending accelerated in FY10–12, bringing India closer to its Single Borrower Limit (SBL) of US$17.5 billion. To help maintain India's IBRD net exposure within the SBL and ensure medium-term sustainability of the India program, the Reserve Bank of India (RBI, the central bank) has agreed in principle with the IBRD and the Bank for International Settlements to purchase up to US$4.3 billion in IBRD Special Private Placement Bonds.

The overarching objective of the current CAS is to scale up the development impact of Bank Group assistance to help India achieve rapid inclusive growth, sustainable development, and improved service delivery. It aims to do this while strengthening project implementation, improving the effectiveness of public spending, and achieving demonstrable results to scale up the impact of World Bank assistance. The diversity of India calls for a differentiated, tailored approach. In India's low-income states and in lagging regions of more advanced states, the focus is on achieving the MDGs, relying primarily on IDA resources and non-lending technical assistance. In more advanced states and at the central level, the focus is on strengthening institutions so that they can deal with emerging middle income challenges, relying on IBRD lending and cutting-edge analytical work. In the context of WBG India CAS, IFC's three strategic pillars are inclusive growth, climate change and regional and global integration. IFC is prioritizing support for the low-income and North East States in order to better promote inclusive growth.

The new India Country Program Strategy (CPS) for 2013–2016 is currently under preparation. The overarching objective of the new CPS will be to support India in lifting more people out of poverty, and ensuring that the new "non-poor" and their future generations have opportunities that would allow them to prosper. The Bank's engagement will be guided by the Government's vision of how best to use the financing and expertise from multi-lateral institutions to address India's development challenges. The program will focus on projects that are transformational, innovative and/or those that leverage significant resources, both domestic and international sources and the private sector. The approach allows for the application of selectivity principles across the pipeline of projects and encourages scaling up efforts to leverage private finance with IBRD investments. IFC will continue to encourage private sector commercial investment through mobilization, by collaboration with leading banks and non-banking financial companies. It will support smaller entities through direct equity or debt investment, provide targeted technical assistance and facilitate global knowledge sharing. IFC advisory services will continue supporting investment climate reforms in low-income states, providing sustainable business advisory, improving access to finance and supporting public-private partnerships.

India: World Bank Financial Operations

	(In millions of U.S. dollars)1/
	2011/12 2/
Commitments 3/	**5,717**
IBRD	2,869
IDA	2,848
Disbursement	**2,527**
IBRD	991
IDA	1,536
Repayments	**1,544**
IBRD	642
IDA	902
Debt outstanding and disbursed	**38,374**
IBRD	11,617
IDA	26,757

Source: World Bank.

1/ On an Indian fiscal year basis beginning April 1.

2/ April 1, 2011 through March 31, 2012.

3/ Based on loan approval date.

ANNEX III. RELATIONS WITH THE ASIAN DEVELOPMENT BANK

The Asian Development Bank (AsDB) operations in India began in 1986. Cumulative public sector loan commitments totaled $27.2 billion as of 31 December 2012 for 168 loans. With an additional $2.3 billion in private sector loans (the latter without government guarantee), total loan commitments on a cumulative basis amount to $29.5 billion. These funds have been provided from AsDB's ordinary capital resources (OCR). Also, AsDB has approved equity investments amounting to $0.3 billion. AsDB's lending and equity activities are summarized below.

India: Asian Development Bank Financial Operations (sovereign and non-sovereign)
(In millions of U.S. dollars, as of 31 December 2012)

Calendar Year	OCR Loan Commitments	Private Equity	Disbursements
1986–90	2,361.3	15.9	354.3
1991–95	3,456.0	59.5	2,222.8
1996	763.0	--	605.6
1997	563.0	15.5	645.0
1998	250.0	--	620.4
1999	625.0	--	605.1
2000	1,330.0	--	487.0
2001	1,500.0	--	269.8
2002	1,183.6	15.0	576.5
2003	1,493.0	0.7	658.2
2004	1,200.0	29.7	401.6
2005	417.3	15.0	698.3
2006	1,485.0	67.6	711.9
2007	1,311.4	--	1,493.2
2008	2,482.6	18.6	1,655.6
2009	1,811.0	40.0	1,551.7
2010	2,119.6	0.0	1,858.1
2011	2,872.9	20.0	1,544.6
2012	2,290.0	--	1,041.0 1/
Total	**29,514.7**	**297.5**	**18,000.9**

Source: Asian Development Bank.
1/ As of 31 October 2012.

AsDB's India Country Partnership Strategy (2009–2012) (CPS) is based on four strategic pillars: (i) Support for the process of inclusive and environmentally sustainable growth; (ii) Catalyzing investment through the use of innovative business and financing modalities; (iii) Strengthening the results orientation of project design and implementation and emphasizing knowledge solutions; and (iv) Support for regional cooperation. The CPS has been designed to support Government of India's efforts in facilitating inclusive growth and speeding up the pace of poverty reduction and social development as emphasized in the Eleventh Five-Year Plan (2007–2012). It has been prepared within a results-based framework, and aims at significantly strengthening AsDB support for infrastructure development in the relatively poorer states of India, promoting public private partnerships in infrastructure, supporting climate change adaptation and mitigation, and encouraging the use of innovative financing modalities (non-sovereign loans and cofinancing) to enhance the leverage of AsDB operations.

ANNEX IV. STATISTICAL ISSUES

1. Macroeconomic statistics are adequate for surveillance, but weaknesses remain in the timeliness and coverage of certain statistical series. India has an intricate system for compiling economic and financial statistics and produces a vast quantity of data covering most sectors of the economy. India subscribed to the Special Data Dissemination Standards (SDDS) on December 27, 1996 and started posting its metadata on the Dissemination Standards Bulletin Board on October 30, 1997. It is currently in observance of the SDDS, although it uses flexibility options for timeliness of data on general government operations and on the periodicity and timeliness of labor market data.

2. The data module of the Report on Observance of Standards and Codes (ROSC, IMF Country Report No. 04/96) was published in April 2004. It assesses India's data dissemination practices against the SDDS requirements and assesses the quality of six datasets based on the Data Quality Assessment Framework (DQAF) developed by STA.

3. **National accounts and employment statistics:** The Central Statistical Organization (CSO) releases a new series of national accounts, with base year 2004–2005 with a dissemination lag for quarterly releases of two months. Large revisions to historical series and major discrepancies between supply and expenditure national accounts complicate analysis: these differences have become larger in recent quarters. Supply-side data remain of better quality than expenditure-side data. Estimates of value added in constant prices for public administration and defense may be biased upwards, as they are based on the government's wage bill (with arrears counted in the year that they are paid) deflated by the Wholesale Price Index (WPI). There are long standing deficiencies in employment data: they are only available on an annual basis and with a substantial lag, and they only cover the formal sector, which accounts for a small segment of the labor market.

4. **Price statistics:** Since January 2006, the Labour Bureau has published a CPI for industrial workers with a 2001 base year. A revised all-India CPI with new weights was unveiled in early 2011. Presently, there are four CPIs, each based on the consumption basket of a narrow category of consumers (namely industrial workers, urban and non-manual employees, agricultural laborers, and rural laborers). The CPIs are published with a lag of about one month. With the exception of the industrial workers CPI, the other indices are based on weights that are over ten years. The WPI was also recently revised and has a 2004/05 base year. Data are also subject to frequent and large revision, usually upward. New RBI price series on residential real estate have helped surveillance in this area, though geographic coverage remains limited, and price data for commercial real estate are not available. The RBI has started producing a series covering rural wage data, which helps surveillance, but economy-wide wage data are scant.

5. **External sector statistics:** While the concepts and definitions used to compile balance of payments statistics are broadly in line with the sixth edition of the Balance of Payments Manual (BPM6). Furthermore, trade data have quality, valuation, timing, and coverage problems, and data on

trade prices, volumes, and composition are not regularly available on a timely basis. Only trade credit extended for more than 180 days is included in the balance of payments (and the IIP and external debt data); trade credit is often less than 180 days in most countries. Bilateral data on services exports to the United States and other developed countries are manifold higher than counterpart services imports published by these same countries. External debt statistics are available on a quarterly basis with a one quarter lag. Estimates of short-term external debt are presented in the debt statistics on an original maturity basis. The short-term maturity attribution on a residual maturity basis is only available annually (and excludes residual maturity of medium- and long-term nonresident Indian accounts). The international investment position (IIP) statistics cover the sectors prescribed in the BPM6 and these data are disseminated within six months of the reference period in respect of annual data[1]. Coverage of direct investment positions data is hampered by the absence of appropriate legal or institutional authority. India began disseminating the Data Template on International Reserves and Foreign Currency Liquidity as prescribed under the SDDS in December 2001. The more up-to-date information on certain variables, such as total foreign reserves, foreign currency assets, gold, and SDRs, are available on a weekly basis and are disseminated as part of a weekly statistical supplement on the RBI web site.

6. **Monetary and financial statistics:** The RBI web site and the RBI Bulletin publish a wide array of monetary and financial statistics, including reserve money and its components, RBI's survey, monetary survey, liquidity aggregates (outstanding amounts), interest rates, exchange rates, foreign reserves, and results of government securities auctions. In 2011, the RBI started publishing a weighted average lending interest rate and other lending rates at annual frequency. The frequency and quality of data dissemination have improved substantially in recent years.

7. Concepts and definitions used by the RBI to compile monetary statistics are in broad conformity with the guidelines provided in the Monetary and Financial Statistics Manual (MFSM). Nevertheless, the following concepts and principles deviate from the MFSM. First, the resident sector data do not provide sufficient information on the sectoral distribution of domestic credit. Specifically, under their present sectorization scheme, the authorities subdivide the resident nonbank sector data by (i) central government; (ii) state government; and (iii) the commercial sector (including other financial corporations, public and other nonfinancial corporations, and other resident sectors). Second, commercial banks add accrued interest to credit and deposit positions on a quarterly basis only (instead of the prescribed monthly basis).

8. The RBI reports monetary data for IFS on a regular basis. Since October 2006, the RBI has initiated the electronic reporting of monetary data, which is a major improvement from the previous paper-based reporting which was prone to errors and delays. India has also submitted to STA test data (starting from December 2001 data) on the Standardized Report Forms (SRFs) that have been

[1] The IIP as published by the RBI values equity liabilities at acquisition cost, while the Fund uses market prices, resulting in substantial differences.

developed to implement the methodology outlined in the MFSM. STA is working with the authorities in resolving the outstanding data issues on the development of the SRFs.

9. **Government finance statistics:** The Ministry of Finance (MoF) is responsible for compiling and disseminating the GFS. India reports the budgetary central government cash flow statement within one month after the reference month and stock of liabilities within one quarter after the reference quarter. With the agreement of the authorities, STA uses these data to compile a monthly cash flow statement for publication in the *International Financial Statistics*, following the *GFSM 2001* presentation, with some missing breakdowns, particularly for expenditure. Data on fiscal performance at the state level are available only at annual frequency and with a considerable lag. Data on the functional and economic classification of expenditures are available with considerable lag. There is also scope to improve the analytical usefulness of the presentation of the fiscal accounts. For example, classification of government expenditure between developmental/nondevelopmental and plan/nonplan obscures the economic nature and impact of fiscal actions. The MoF reports central government data (on a cash basis) for publication in the *Government Finance Statistics Yearbook* (GFSY), the latest reported data corresponding to 2010. Two years after the reference year, the Ministry of Finance reports general government data to STA in the *GFSM 1986* format, that staff reworks to the *GFSM 2001* presentation for inclusion in the GFSY (latest reported data correspond to 2008). Data on the general government operations are not internationally comparable as they exclude data on the operations of the extra-budgetary funds, local governments, and social security funds. Under the SDDS, India disseminates annual general government data within 3 quarters after the reference year, using the timeliness flexibility option but meets the SDDS specifications for central government debt and operations.

India: Table of Common Indicators Required for Surveillance

As of December 6, 2012

	Date of latest observation	Date received	Frequency of Data 1/	Frequency of Reporting 1/	Frequency of Publication 1/
Exchange Rates	12/06/12	12/06/12	D	D	D
International reserve assets and reserve liabilities of the monetary authorities 3/	11/23/12	11/30/12	W	W	W
Reserve/base money	11/30/12	12/05/12	W	W	W
Broad money	11/16/12	11/29/12	W	W	W
Central bank balance sheet	Oct. 2012	11/2/12	M	M	M
Consolidated balance sheet of the banking system	Oct. 2012	11/13/12	M	M	M
Interest rates 4/	12/06/12	12/06/12	D	D	D
Consumer price index	Oct. 2012	11/30/12	M	M	M
Revenue, expenditure, balance and composition of financing - General Government 5/ 6/	2012/13	11/30/12	A	A	A
Revenue, expenditure, balance and composition of financing - Central Government 5/ 6/	Oct. 2012	11/30/12	M	M	M
Stocks of central government and central government-guaranteed debt 7/	2010/11	10/3/12	A	A	A
External current account balance	Jun. 2012	9/28/12	Q	Q	Q
Exports and imports of goods and services	Jun. 2013	9/29/12	Q	Q	Q
GDP/GNP	Sep. 2012	11/30/12	Q	Q	Q
Gross external debt	Jun. 2012	9/28/12	Q	Q	Q
International Investment Position	Sep. 2012	11/9/12	Q	Q	Q

1/ Daily (D), Weekly (W), Biweekly (BW), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA)
3/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
4/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
5/ Foreign, domestic bank, and domestic nonbank financing.
6/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state governments
7/ Including currency and maturity composition

INTERNATIONAL MONETARY FUND

INDIA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

December 21, 2012

Approved By
Masahiko Takeda and Tamim Bayoumi

Prepared by the Staff Representatives of the 2013 Consultation with India

CONTENTS

ANNEX I. MEDIUM-TERM PUBLIC DEBT SUSTAINABILITY ANALYSIS

Macroeconomic Assumptions. Growth is forecast at 5.4 percent in 2012/13, and should slowly return to trend in the medium term. The WPI is expected to fall from 7¾ percent at end-2012/13 to around 5 percent in the medium term. This baseline scenario assumes continued implementation of structural reforms that do not require legislative approval, and a relatively benign global scenario.

Fiscal Assumptions. The 2012/13 central government budget deficit is expected to reach 5.8 percent of GDP. This corresponds to 5.6 percent under the authorities' definition. Over the medium term, this is expected to decline slowly toward 5¼ percent of GDP, while state government deficits should remain contained at or slightly below 3 percent of GDP.

- Tax performance, especially for corporate income taxes, is expected to increase slightly as ongoing administrative measures continue to be implemented. Base broadening is expected to continue, but with exemptions from the services tax already quite limited, gains are expected to be slight. GST is not assumed in this baseline as it requires legislative changes, including a constitutional amendment.

- At the same time, some savings are likely to be found from fertilizer and petroleum subsidies, and the planned gradual introduction of cash transfers should help rationalize spending over the medium term.

- Other expenditures are expected to remain contained in the medium term, with current expenditure rising modestly at the central government level and capital expenditure remaining close to current levels.

- Debt is expected to rise over the medium term by around 2 percentage points as public banks are recapitalized to reach Basel III targets and as some of the debts of electricity distribution companies are assumed by the government, in line with recent announcements.

A. Sensitivity Analysis

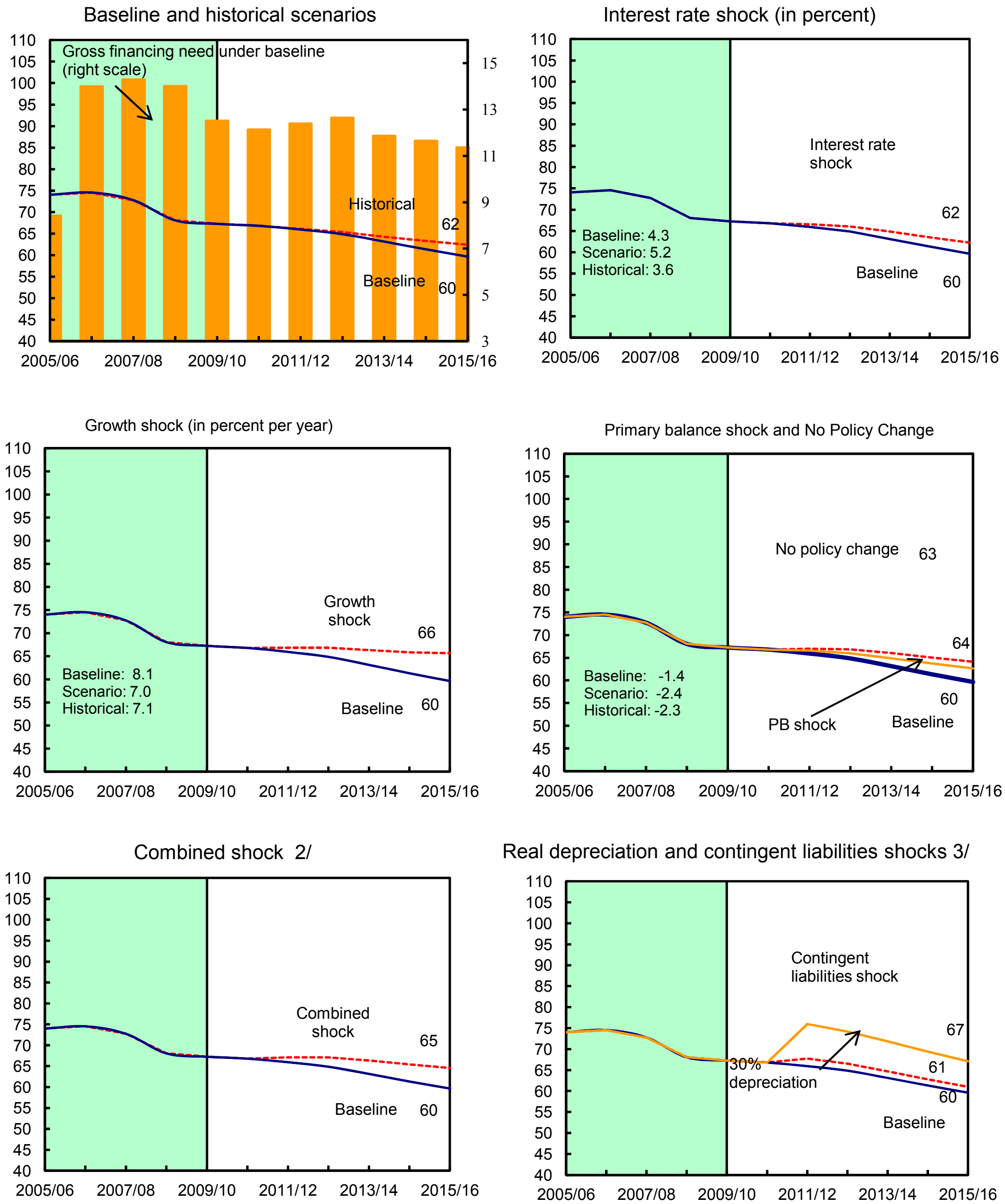
Baseline. India's still relatively high nominal GDP growth means that its debt-stabilizing primary balance is -4.7 percent of GDP. With the primary balance currently close to this level and expected to improve in the medium term, the debt-to-GDP ratio is forecast to decline modestly, at around 1–1½ percentage points a year. After falling by just over 8 percentage points of GDP from its crisis peak of 75.4 percent to a provisional 67.3 percent in 2011/12, due to high nominal GDP growth, the debt to GDP ratio is forecast to fall by 7.2 percentage points by 2017/18, reaching 60 percent.

Other Scenarios. A one-half standard deviation shock to GDP growth, which effectively would be a continuation of the current slowdown, would end consolidation, and keep the debt ratio broadly constant. With the primary deficit now slightly below debt stabilizing levels, a scenario of unchanged policies would result in a marginal decline in debt over the medium term, while a half-standard deviation shock to interest rates would not fundamentally alter the level or dynamics of debt. Further contingent liabilities could arise from losses at public banks or other state-owned companies, but even a large shock would have mostly a level effect on debt, and under conditions similar to the baseline, the debt ratio would continue to decline.

Policy Risks. On the upside, better tax buoyancy, a GST and a new Direct Tax Code that improve efficiency and lead to near-term revenue gains, or a strong revival of the economy could return India to the favorable debt dynamics prevailing before the crisis. On the downside, should diesel prices again fall below global levels, savings not materialize from fertilizer and other fuel subsidy reforms, or tax takes not return to pre-crisis levels, then debt dynamics would either stabilize at current levels or possibly worsen.

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

(Public debt, in percent of GDP)



Source: Fund staff estimates; fiscal year data.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table I.2. India: Public Sector Debt Sustainability Framework, 2007/08-2017/18

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	74.0	74.5	72.8	68.1	67.3	**66.8**	**66.0**	**64.9**	**63.1**	**61.3**	**59.6**	**-4.7**
o/w foreign-currency denominated	4.3	4.7	3.9	3.6	3.6	3.2	2.9	2.6	2.3	2.0	1.8	
Change in public sector debt	-3.1	0.5	-1.8	-4.7	-0.8	-0.5	-0.9	-1.1	-1.7	-1.8	-1.7	
Identified debt-creating flows (4+7+12)	-6.6	2.6	-0.6	-3.8	0.1	0.2	-1.1	-1.3	-1.3	-1.4	-1.4	
Primary deficit	-0.8	4.9	4.9	4.9	4.5	4.2	3.6	3.7	3.6	3.4	3.5	
Revenue and grants	22.0	19.7	18.6	19.1	18.6	18.4	18.7	18.8	18.9	18.9	19.0	
Primary (noninterest) expenditure	21.2	24.6	23.4	24.1	23.1	22.7	22.4	22.5	22.4	22.4	22.5	
Automatic debt dynamics 2/	-5.9	-2.3	-5.1	-7.0	-4.2	-3.8	-4.3	-4.6	-4.6	-4.6	-4.6	
Contribution from interest rate/growth differential 3/	-5.5	-3.4	-4.6	-7.0	-4.6	-3.8	-4.3	-4.6	-4.6	-4.6	-4.6	
Of which contribution from real interest rate	1.0	-0.9	0.7	-1.1	-0.6	-1.1	-0.9	-0.9	-0.8	-0.9	-1.0	
Of which contribution from real GDP growth	-6.5	-2.6	-5.4	-5.8	-4.0	-2.7	-3.5	-3.7	-3.8	-3.7	-3.7	
Contribution from exchange rate depreciation 4/	-0.4	1.1	-0.5	0.0	0.4	...	...	...	...	...	...	
Other identified debt-creating flows	0.1	0.0	-0.4	-1.7	-0.2	-0.3	-0.4	-0.4	-0.2	-0.2	-0.2	
Privatization receipts (negative)	-0.1	0.0	-0.4	-1.7	-0.2	-0.3	-0.4	-0.4	-0.2	-0.2	-0.2	
Recognition of implicit or contingent liabilities	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	3.5	-2.1	-1.1	-0.9	-0.9	-0.6	0.3	0.2	-0.4	-0.4	-0.3	
Public sector debt-to-revenue ratio 1/	337.1	378.2	391.7	355.6	361.9	362.4	352.4	345.4	334.8	323.9	313.5	
Gross financing need 6/	8.4	14.0	14.3	14.0	12.5	12.1	12.4	12.6	11.9	11.6	11.4	
in billions of U.S. dollars	104.2	171.2	194.6	235.9	231.1	240.8	269.3	302.9	315.4	346.2	384.6	
Scenario with key variables at their historical averages 7/						**66.8**	**66.1**	**65.4**	**64.3**	**63.3**	**62.4**	**-3.7**
Scenario with no policy change (constant primary balance) in 2012/13-2017/18						**66.8**	**66.6**	**66.0**	**64.9**	**63.7**	**62.6**	**-4.9**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	9.8	3.9	8.2	9.6	6.9	4.5	6.0	6.5	6.8	6.9	7.0	
Average nominal interest rate on public debt (in percent) 8/	7.8	7.7	7.6	7.5	7.5	7.6	8.5	8.3	8.1	7.9	7.7	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.1	-1.0	1.6	-1.0	-0.5	-1.5	-0.9	-1.0	-0.8	-1.0	-1.2	
Nominal appreciation (increase in US dollar value of local currency, in percent)	9.1	-21.3	12.6	1.1	-10.6	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	5.8	8.7	6.0	8.5	8.0	9.1	9.4	9.3	9.0	9.0	9.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	10.1	20.8	3.0	12.5	2.6	2.5	4.6	7.0	6.6	6.8	7.6	
Primary deficit	-0.8	4.9	4.9	4.9	4.5	4.2	3.6	3.7	3.6	3.4	3.5	

1/ General government (Center and States); debt refers to gross debt.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

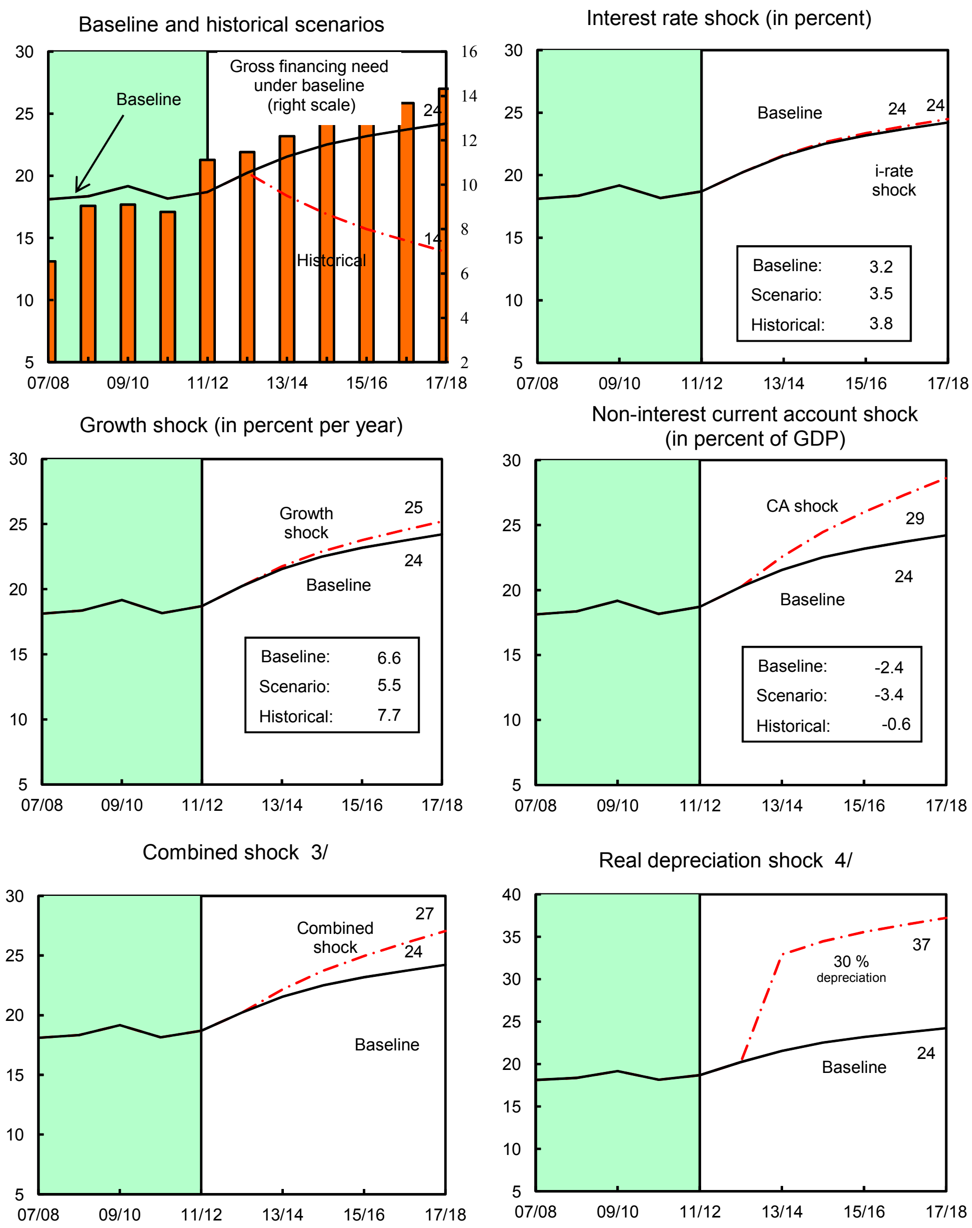
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

ANNEX II. MEDIUM-TERM EXTERNAL DEBT SUSTAINABILITY ANALYSIS

Figure 1. India: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2013/14.

Table 1. India: External Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing non-interest current account 6/
Baseline: External debt	18.1	18.4	19.2	18.2	18.7	**20.2**	**21.5**	**22.5**	**23.2**	**23.7**	**24.2**	**-3.6**
Change in external debt	0.0	0.2	0.8	-1.0	0.5	1.5	1.3	1.0	0.7	0.5	0.5	
Identified external debt-creating flows (4+8+9)	-6.2	1.5	-2.8	-3.2	0.4	1.1	0.4	-0.1	-0.5	-0.8	-0.8	
Current account deficit, excluding interest payments	0.6	1.6	2.3	2.3	3.7	3.5	3.1	2.7	2.2	2.0	1.8	
Deficit in balance of goods and services	4.2	5.4	6.0	4.9	6.8	6.1	5.6	5.2	4.7	4.4	4.2	
Exports	20.7	24.1	20.5	22.8	24.5	22.4	21.7	21.3	21.2	21.0	20.8	
Imports	-25.0	-29.5	-26.5	-27.6	-31.3	-28.5	-27.4	-26.5	-25.9	-25.4	-25.0	
Net non-debt creating capital inflows (negative)	-3.5	-0.7	-3.7	-2.4	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	
Automatic debt dynamics 1/	-3.3	0.6	-1.5	-3.2	-1.1	-0.4	-0.7	-0.7	-0.7	-0.7	-0.5	
Contribution from nominal interest rate	0.7	0.7	0.5	0.4	0.6	0.4	0.4	0.5	0.7	0.7	0.9	
Contribution from real GDP growth	-1.4	-0.7	-1.4	-1.5	-1.1	-0.8	-1.1	-1.3	-1.4	-1.4	-1.5	
Contribution from price and exchange rate changes 2/	-2.6	0.6	-0.6	-2.1	-0.6	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	6.1	-1.2	3.6	2.2	0.1	0.5	0.9	1.0	1.2	1.3	1.3	
External debt-to-exports ratio (in percent)	87.5	76.1	93.7	79.8	76.5	90.3	99.1	105.5	109.5	112.9	116.4	
Gross external financing need (in billions of US dollars) 4/	81.0	110.7	123.8	147.8	205.4	229.2	266.7	307.6	354.1	406.9	473.8	
in percent of GDP	6.5	9.0	9.1	8.8	11.1	11.5	12.2	12.8	13.2	13.7	14.3	
Scenario with key variables at their historical averages 5/						**20.2**	**18.4**	**16.9**	**15.7**	**14.8**	**13.9**	**-3.4**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	9.8	3.9	8.2	9.6	6.9	4.5	6.0	6.5	6.8	6.9	7.0	
GDP deflator in US dollars (change in percent)	18.8	-4.9	2.8	13.0	2.7	3.5	3.2	3.5	3.9	4.0	3.9	
Nominal external interest rate (in percent)	4.7	3.8	2.8	2.7	3.4	2.2	2.3	2.7	3.5	3.3	4.4	
Growth of exports (US dollar terms, in percent)	26.6	15.0	-5.6	37.7	17.9	-0.9	6.2	8.3	10.1	10.3	10.0	
Growth of imports (US dollar terms, in percent)	31.6	16.6	0.0	29.0	24.2	-1.3	5.0	6.9	8.3	9.2	9.4	
Current account balance, excluding interest payments	-0.6	-1.6	-2.3	-2.3	-3.7	-3.5	-3.1	-2.7	-2.2	-2.0	-1.8	
Net non-debt creating capital inflows	3.5	0.7	3.7	2.4	2.1	2.1	2.1	2.1	2.1	2.1	2.1	

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

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

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

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

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

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

Table 1. India: External Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing non-interest current account 6/
Baseline: External debt	18.1	18.4	19.2	18.2	18.7	**20.2**	**21.5**	**22.5**	**23.2**	**23.7**	**24.2**	**-3.6**
Change in external debt	0.0	0.2	0.8	-1.0	0.5	1.5	1.3	1.0	0.7	0.5	0.5	
Identified external debt-creating flows (4+8+9)	-6.2	1.5	-2.8	-3.2	0.4	1.1	0.4	-0.1	-0.5	-0.8	-0.8	
Current account deficit, excluding interest payments	0.6	1.6	2.3	2.3	3.7	3.5	3.1	2.7	2.2	2.0	1.8	
Deficit in balance of goods and services	4.2	5.4	6.0	4.9	6.8	6.1	5.6	5.2	4.7	4.4	4.2	
Exports	20.7	24.1	20.5	22.8	24.5	22.4	21.7	21.3	21.2	21.0	20.8	
Imports	-25.0	-29.5	-26.5	-27.6	-31.3	-28.5	-27.4	-26.5	-25.9	-25.4	-25.0	
Net non-debt creating capital inflows (negative)	-3.5	-0.7	-3.7	-2.4	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	
Automatic debt dynamics 1/	-3.3	0.6	-1.5	-3.2	-1.1	-0.4	-0.7	-0.7	-0.7	-0.7	-0.5	
Contribution from nominal interest rate	0.7	0.7	0.5	0.4	0.6	0.4	0.4	0.5	0.7	0.7	0.9	
Contribution from real GDP growth	-1.4	-0.7	-1.4	-1.5	-1.1	-0.8	-1.1	-1.3	-1.4	-1.4	-1.5	
Contribution from price and exchange rate changes 2/	-2.6	0.6	-0.6	-2.1	-0.6	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	6.1	-1.2	3.6	2.2	0.1	0.5	0.9	1.0	1.2	1.3	1.3	
External debt-to-exports ratio (in percent)	87.5	76.1	93.7	79.8	76.5	90.3	99.1	105.5	109.5	112.9	116.4	
Gross external financing need (in billions of US dollars) 4/	81.0	110.7	123.8	147.8	205.4	229.2	266.7	307.6	354.1	406.9	473.8	
in percent of GDP	6.5	9.0	9.1	8.8	11.1	11.5	12.2	12.8	13.2	13.7	14.3	
Scenario with key variables at their historical averages 5/						**20.2**	**18.4**	**16.9**	**15.7**	**14.8**	**13.9**	**-3.4**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	9.8	3.9	8.2	9.6	6.9	4.5	6.0	6.5	6.8	6.9	7.0	
GDP deflator in US dollars (change in percent)	18.8	-4.9	2.8	13.0	2.7	3.5	3.2	3.5	3.9	4.0	3.9	
Nominal external interest rate (in percent)	4.7	3.8	2.8	2.7	3.4	2.2	2.3	2.7	3.5	3.3	4.4	
Growth of exports (US dollar terms, in percent)	26.6	15.0	-5.6	37.7	17.9	-0.9	6.2	8.3	10.1	10.3	10.0	
Growth of imports (US dollar terms, in percent)	31.6	16.6	0.0	29.0	24.2	-1.3	5.0	6.9	8.3	9.2	9.4	
Current account balance, excluding interest payments	-0.6	-1.6	-2.3	-2.3	-3.7	-3.5	-3.1	-2.7	-2.2	-2.0	-1.8	
Net non-debt creating capital inflows	3.5	0.7	3.7	2.4	2.1	2.1	2.1	2.1	2.1	2.1	2.1	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate,
ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

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

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

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

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

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

Table 1. India: External Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	18.1	18.4	19.2	18.2	18.7	**20.2**	**21.5**	**22.5**	**23.2**	**23.7**	**24.2**	**-3.6**
Change in external debt	0.0	0.2	0.8	-1.0	0.5	1.5	1.3	1.0	0.7	0.5	0.5	
Identified external debt-creating flows (4+8+9)	-6.2	1.5	-2.8	-3.2	0.4	1.1	0.4	-0.1	-0.5	-0.8	-0.8	
Current account deficit, excluding interest payments	0.6	1.6	2.3	2.3	3.7	3.5	3.1	2.7	2.2	2.0	1.8	
Deficit in balance of goods and services	4.2	5.4	6.0	4.9	6.8	6.1	5.6	5.2	4.7	4.4	4.2	
Exports	20.7	24.1	20.5	22.8	24.5	22.4	21.7	21.3	21.2	21.0	20.8	
Imports	-25.0	-29.5	-26.5	-27.6	-31.3	-28.5	-27.4	-26.5	-25.9	-25.4	-25.0	
Net non-debt creating capital inflows (negative)	-3.5	-0.7	-3.7	-2.4	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	
Automatic debt dynamics 1/	-3.3	0.6	-1.5	-3.2	-1.1	-0.4	-0.7	-0.7	-0.7	-0.7	-0.5	
Contribution from nominal interest rate	0.7	0.7	0.5	0.4	0.6	0.4	0.4	0.5	0.7	0.7	0.9	
Contribution from real GDP growth	-1.4	-0.7	-1.4	-1.5	-1.1	-0.8	-1.1	-1.3	-1.4	-1.4	-1.5	
Contribution from price and exchange rate changes 2/	-2.6	0.6	-0.6	-2.1	-0.6	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	6.1	-1.2	3.6	2.2	0.1	0.5	0.9	1.0	1.2	1.3	1.3	
External debt-to-exports ratio (in percent)	87.5	76.1	93.7	79.8	76.5	90.3	99.1	105.5	109.5	112.9	116.4	
Gross external financing need (in billions of US dollars) 4/	81.0	110.7	123.8	147.8	205.4	229.2	266.7	307.6	354.1	406.9	473.8	
in percent of GDP	6.5	9.0	9.1	8.8	11.1	11.5	12.2	12.8	13.2	13.7	14.3	
Scenario with key variables at their historical averages 5/						**20.2**	**18.4**	**16.9**	**15.7**	**14.8**	**13.9**	**-3.4**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	9.8	3.9	8.2	9.6	6.9	4.5	6.0	6.5	6.8	6.9	7.0	
GDP deflator in US dollars (change in percent)	18.8	-4.9	2.8	13.0	2.7	3.5	3.2	3.5	3.9	4.0	3.9	
Nominal external interest rate (in percent)	4.7	3.8	2.8	2.7	3.4	2.2	2.3	2.7	3.5	3.3	4.4	
Growth of exports (US dollar terms, in percent)	26.6	15.0	-5.6	37.7	17.9	-0.9	6.2	8.3	10.1	10.3	10.0	
Growth of imports (US dollar terms, in percent)	31.6	16.6	0.0	29.0	24.2	-1.3	5.0	6.9	8.3	9.2	9.4	
Current account balance, excluding interest payments	-0.6	-1.6	-2.3	-2.3	-3.7	-3.5	-3.1	-2.7	-2.2	-2.0	-1.8	
Net non-debt creating capital inflows	3.5	0.7	3.7	2.4	2.1	2.1	2.1	2.1	2.1	2.1	2.1	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

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

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

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

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

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

Statement by the IMF Staff Representative on India
January 25, 2013

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

Economic and financial developments

1. **Recent activity data point to a modest recovery.** In sequential terms, industrial production (IP) has grown for two consecutive months since October, but capital goods production remains weak. PMI data indicate a further improvement in December. Negative growth in mining and low electricity output growth suggest that supply-side bottlenecks persist.

2. **Headline WPI inflation has moderated, but CPI inflation has risen.** In December, headline and core WPI inflation declined to 7.2 percent y/y and 4.2 percent y/y, respectively. National CPI inflation, however, accelerated to 10.6 percent y/y due to food and fuel prices. The decline in WPI may be short-lived, as CPI trends inform inflation expectations and wages. Market participants expect the RBI to cut rates in its January 29 review.

3. **The 2012Q3 current account deficit widened to 5.4 percent of GDP, but the financing mix improved.** Merchandise exports fell by 12.2 percent y/y and imports by 4.8 percent y/y. Moderate growth in remittances, weaker services, and a rise in net outflows of investment income contributed to the increase in the current account deficit (CAD). Though the trade deficit narrowed marginally in December, risks have increased that the 2012/13 CAD could exceed staff projections by ¼–½ percent of GDP. With net capital inflows rising to US$24 billion in 2012Q3 from US$16 billion in Q2 mainly due to higher FDI and a turnaround in portfolio flows, the balance of payments recorded a small deficit in 2012 Q3. The authorities have extended interest subsidies for exports until March 2014 and introduced measures to enhance the flow of credit to the sector.

4. **Banks' asset quality continued to deteriorate.** Gross nonperforming assets (NPAs) increased to 3.6 percent of total advances in September 2012 from 3.2 percent in June 2012, while net NPAs increased to 1.7 percent from 1.5 percent in June 2012. Restructured loans rose to 5.9 percent of loans in September 2012 from 5.4 percent in June 2012, with the public sector banks continuing to experience the highest degree of deterioration in asset quality.

5. **Recent subsidy measures bode well provided implementation is sustained.** On January 17, 2013, the government increased flexibility in diesel pricing leading oil companies to raise prices by half a rupee, and announced that bulk users of diesel would no longer receive the subsidized price. At the same time, the number of cooking fuel cylinders eligible for subsidized purchase was increased. The net impact for the current year would be slightly less than 0.1 percent of GDP, but if diesel prices continue to be raised by the same amount every month, these changes would result in savings of up to ¾ percent of GDP in 2013/14. Additionally, the government has begun implementation of direct cash transfers for

some social programs in 20 districts and has announced that it will expand these pilots as well as the programs covered.

6. **Nevertheless, some overrun of the central government deficit target remains likely.** The budget deficit in the first eight months of 2012/13 reached 4.1 percent of GDP and remains likely to overrun the government's 5.3 percent full-year target, despite tightened expenditure control. On the other hand, data also show that the deficit position of state governments is better than previously estimated. Finally, the government announced changes to its rules aimed at preventing tax avoidance, which will delay implementation until 2016 and reduce the impact on most institutional investors, reducing uncertainty.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 13/14
FOR IMMEDIATE RELEASE
February 6, 2013

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with India

On January 25, the Executive Board of the International Monetary Fund (IMF) concluded the 2013 Article IV consultation with India.[1]

Background

Although India's growth remains one of the highest in the world, it has slowed markedly and inflation remains elevated. The slowdown has been due to structural and supply-side factors, with cyclical and global factors also contributing. Capital inflows remain resilient suggesting that the financial channel has not been prominent in the transmission of external shocks. Mainly led by falling infrastructure and corporate investment, the slowdown has now generalized to exports and private consumption. The current account deficit widened to 4.2 percent of GDP in 2011/12, causing the rupee to depreciate sharply before its recent stabilization. The financial positions of banks and corporates, both strong before 2009, have deteriorated. With policy space strictly circumscribed because of high fiscal deficit and elevated inflation, the economy is in a weaker position than before the global financial crisis. In recent months, the authorities have taken steps to reverse the slowdown, which have led to improved market sentiment.

Growth is projected at about 5½ percent for 2012/13, but should pick up to 6 percent in 2013/14. Continued implementation of measures to facilitate investment and slightly stronger global growth should deliver a modest rebound in the near term. Inflation is forecasted to remain above the Reserve Bank of India's comfort zone given that supply constraints are likely to ease

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

only gradually. The current account deficit should narrow marginally this year to about 4 percent of GDP, aided by falling gold imports, a weaker rupee, and broadly stable oil prices.

Risks are on the downside, but recent government action has mitigated domestic risks. The uncertain global situation could present serious challenges to India, especially in case of a major global financial shock, and the macroeconomic environment limits the scope for policy response. On the domestic front, insufficient follow-through on recent reforms, in particular those intended to relieve supply constraints, or resorting to expansionary fiscal policy are key downside risks. On the upside, going beyond announced reforms or legislative progress would lead to higher growth and lower vulnerabilities.

Executive Board Assessment

Executive Directors noted that India's growth has slowed markedly due to structural and cyclical factors, while inflation remains elevated. Directors noted, however, that growth prospects continue to be strong and welcomed the authorities' recent measures to address supply constraints and revive investment activity. Structural reforms, fiscal consolidation, and low inflation were seen as critical for a sustained recovery and to lower vulnerabilities.

Directors considered that growth risks are on the downside, but recent government action has mitigated domestic risks. Stressing that the uncertain global situation could present serious challenges for India, they maintained that the flexible rupee would continue to be an important buffer, as the scope for countercyclical fiscal and monetary policy is limited.

Directors agreed that with financial conditions still relatively easy, it is advisable to maintain the current level of policy rates until inflation is clearly on a downward trend. They commended the RBI's vigilance on inflation and expected that it will pay dividends for long-term growth. They suggested that more guidance from the RBI on future projected inflation may be helpful in anchoring inflation expectations.

Directors welcomed the government's fiscal roadmap and underscored the importance of the quality and sustainability of fiscal consolidation. They welcomed the start of implementation of direct cash transfers using India's impressive Unique Identification Number. Directors stressed, however, that rationalizing fuel and fertilizer subsidies is essential to create fiscal space and make the adjustment more equitable. They supported the reorientation of spending from untargeted subsidies to infrastructure investment and social spending. They also underscored the need to raise tax revenues to pre-crisis levels and concurred that the introduction of the Goods and Services Tax should have priority.

Directors noted that external vulnerability appears to have increased because of the deterioration in the current account deficit and the composition of its financing. However, they viewed it as manageable with the support of exchange rate flexibility. They suggested that fiscal consolidation and lower inflation, combined with addressing supply bottlenecks, would help strengthen the external position. Directors welcomed the authorities' moves toward further gradual capital account liberalization and encouraged them to focus on foreign direct investment (FDI) and rupee bonds, which would improve the financing mix and deepen domestic capital markets.

Directors noted that strengthening growth and ensuring its inclusiveness would require tackling structural impediments to investment. They considered that removing obstacles to investment and addressing issues in energy and natural resources would be vital to boost growth. Directors suggested that easing restrictive labor laws, improving agricultural productivity, improving health and education outcomes, and addressing skills mismatches, would make growth more inclusive and would support formal job creation.

To reduce financial risks, Directors encouraged the authorities to tighten mechanisms to address deteriorating asset quality, bring concentration exposure norms in line with international practices, and improve the financial strength of public banks as the 2012 Financial Sector Assessment Program report recommended. They noted that financial reforms are also needed to improve access to credit and diversify funding sources, which in turn will require lowering the statutory liquidity ratio over time as fiscal consolidation progresses.

India: Selected Economic Indicators, 2008/09–2013/14 1/

I. Social Indicators

GDP (2011/12)		**Poverty (percent of population)**	
Nominal GDP (in billions of U.S. dollars):	1,848	Headcount ratio at $1.25 a day (2010):	32.7
GDP per capita (U.S. dollars):	1,526	Undernourished (2008):	19.0
Population characteristics (2011/12)		**Income distribution (2005, WDI)**	
Total (in billions):	1.2	Richest 10 percent of households:	28.3
Urban population (percent of total):	31	Poorest 20 percent of households:	8.6
Life expectancy at birth (years):	65	Gini index (2005):	33.4

II. Economic Indicators

	2008/09	2009/10	2010/11	2011/12 Prel.	2012/13 Proj.	2013/14 2/ Proj.
Growth (y/y percent change)						
Real GDP (at factor cost)	6.7	8.4	8.4	6.5	5.4	6.0
Real GDP (at market prices, calendar year)	6.2	4.9	10.4	7.9	4.5	5.9
Industrial production	2.5	5.3	8.2	2.9	...	...
Prices (y/y percent change, average)						
Wholesale prices (2004/05 weights)	8.1	3.8	9.6	8.9	7.9	7.5
Wholesale prices (2004/05 weights, end of period)	1.6	10.4	9.7	7.7	7.8	7.2
Consumer prices - industrial workers (2001 weights)	9.1	12.4	10.4	8.4	10.8	9.7
Saving and investment (percent of GDP)						
Gross saving 2/	32.0	33.8	32.4	31.3	31.1	31.8
Gross investment 2/	34.3	36.6	35.1	35.5	35.0	35.5
Fiscal position (percent of GDP) 3/						
Central government deficit	-7.8	-7.0	-6.5	-6.0	-5.8	-5.7
General government deficit	-10.0	-9.8	-9.5	-9.0	-8.7	-8.5
General government debt 4/	74.5	72.8	68.1	67.3	66.8	66.0
Money and credit (y/y percent change, end-period)						
Broad money	19.3	16.8	16.1	13.1	19.5	17.9
Credit to commercial sector 5/	16.9	15.8	21.3	17.1	15.5	...
Financial indicators (percent, end-period) 5/						
91-day treasury bill yield	5.0	4.4	7.3	9.0	8.1	...
10-year government bond yield	7.0	7.8	8.0	8.6	8.2	...
Stock market (y/y percent change, end-period)	-37.9	80.5	10.9	-10.5	4.5	...
External trade 6/						
Merchandise exports (in billions of U.S. dollars)	189.0	182.4	250.5	309.8	301.8	317.4
y/y percent change	13.7	-3.5	37.3	23.7	-2.6	5.2
Merchandise imports (in billions of U.S. dollars)	308.5	300.6	381.1	499.5	491.6	521.7
y/y percent change	19.8	-2.6	26.7	31.1	-1.6	6.1
Balance of payments (in billions of U.S. dollars)						
Current account balance	-27.9	-38.2	-45.9	-78.2	-78.0	-78.3
(In percent of GDP)	-2.3	-2.8	-2.7	-4.2	-3.9	-3.6
Foreign direct investment, net	22.4	18.0	9.4	22.1	10.9	21.1
Portfolio investment, net (equity and debt)	-14.0	32.4	30.3	17.2	30.4	23.9
Overall balance	-20.6	13.0	12.9	-13.1	-6.6	0.3
External indicators						
Gross reserves (in billions of U.S. dollars, end-period)	252.0	279.1	304.8	290.3	283.7	284.0
(In months of imports) 7/	8.4	7.2	6.3	6.1	5.7	5.3
External debt (in billions of U.S. dollars, end-period)	224.5	260.9	305.9	345.7	404.5	471.5
External debt (percent of GDP, end-period)	18.4	19.2	18.2	18.7	20.4	21.7
Of which: Short-term debt 8/	6.7	6.7	7.1	7.7	9.0	10.0
Ratio of gross reserves to short-term debt (end-period) 8/	3.1	3.1	2.6	2.0	1.6	1.3
Debt service ratio 9/	5.1	5.0	5.1	5.8	5.7	5.8
Real effective exchange rate						
(y/y percent change, period average for annual data)	-6.8	8.0	11.6	-3.4	...	...
Exchange rate (rupee/U.S. dollar, end-period) 5/	51.2	45.5	45.0	50.3	53.0	...

Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; Bloomberg L.P.; World Bank, *World Development Indicators*; and IMF staff estimates and projections.

1/ Data are for April–March fiscal years.

2/ Differs from official data, calculated with gross investment and current account. Gross investment includes errors and omissions.

3/ Divestment and license auction proceeds treated as below-the-line financing. Subsidy related bond issuance classified as expenditure.

4/ Includes combined domestic liabilities of the center and the states, inclusive of MSS bonds, and external debt at year-end exchange rates.

5/ For 2012/13, as of October 2012.

6/ On balance of payments basis.

7/ Imports of goods and services projected over the following 12 months.

8/ Short-term debt on residual maturity basis, including estimated short-term NRI deposits on residual maturity basis.

9/ In percent of current account receipts, excluding grants.

Statement by Rakesh Mohan, Executive Director for India
and Janak Raj, Senior Advisor
January 25, 2013

1. We welcome staff's comprehensive assessment of recent macroeconomic and financial sector developments in India and the evolving outlook. Our authorities had had a constructive and candid engagement with the mission. The current slowdown in domestic growth is a key concern for our authorities. Accordingly, they have taken a number of measures over the past few months to address various domestic bottlenecks to revive investment activity and growth impulses in the short run, and to boost the growth potential over the medium term.

Recent Macroeconomic Developments

2. Staff have attributed the slowdown of the Indian economy mainly to domestic supply side factors. It needs to be noted, however, that strong global headwinds such as ongoing tensions in the euro area and the concomitant persistent slowdown in global growth also had a significant impact on the economy.

3. In pointing out the role of the domestic supply side factors in India's current growth slowdown, staff are reflecting the concerns of our authorities, who have recognized several constraints that acted as a drag on economic activity recently and had initiated measures to address them. The thrust of the Mid-Year Economic Review presented by the Government to the Parliament in December 2012 was on the domestic constraints that led to a decline in investment activity and slowdown in growth. Some of the major constraints identified are: bottlenecks in project implementation; shortage of coal and underutilization of thermal based power generation; delay in regulatory and environmental clearances; infrastructural bottlenecks; high fiscal deficit; and high inflation. High inflation also mean high interest rates, which have further impacted investment activity.

4. Having recognized these constraints, our authorities have taken measures to address them by following a two-pronged approach. First, measures were initiated to remove short-term constraints, which have already improved business confidence. Second, structural reforms have been pursued to boost the medium-term growth potential of the economy.

Fiscal Policy

5. With tax revenues affected by the slowdown in growth, and expenditures overshooting mainly on account of petroleum subsidies, containing the fiscal deficit in 2012-13 to the budgeted level (5.1 per cent) was proving to be a challenge. Recognizing the need to contain the fiscal deficit, the authorities constituted a high-powered committee in August 2012, based on the recommendations of which a fiscal roadmap was announced in October 2012. Accordingly, our authorities have indicated that the gross

fiscal deficit would be contained at 5.3 per cent in 2012-13 and further brought down to 3.0 per cent by 2016-17. In keeping with this, a number of different measures have been introduced. The domestic prices of administered petroleum products have been increased to contain fuel subsidies. The authorities have also raised railway passenger fares to strengthen the Indian Railways. Earlier, the authorities had announced disinvestment in some public sector enterprises. The authorities are thus committed to containing the fiscal deficit at 5.3 per cent for fiscal year 2012-13.

6. The authorities have also announced a plan to gradually roll out direct cash transfers using Unique Identification Numbers (UID) beginning 2013 in select districts in lieu of existing channels, which are largely in kind and subject to leakages. The authorities expect that by 2016-17, cash transfers will be largely in place for the disbursement of key subsidies. This is an innovative step and is expected to prove very effective in avoiding leakages and delays and lead to better targeting of government programs.

7. It needs to be recognized that even as the fiscal deficit is a concern, India's public debt is on a downward trajectory with the Central Government's gross debt expected to fall to 45.5 per cent of GDP during 2012-13.

Inflation

8. To contain inflation and anchor inflation expectations, the Reserve Bank of India (RBI) has pursued an appropriate monetary policy; it raised the policy interest rate during March 2010 – October 2011. The anti-inflationary monetary policy stance has had some dampening effect on domestic demand, but that was to be expected. As the growth slowed down, the RBI reduced the policy rate in April 2012, but has held its policy rate since then as inflation remained above its comfort level.

Structural Reforms

9. FDI has been permitted in some new sectors, including the multi-brand retail sector, while norms have been relaxed in certain existing sectors. To avoid delay in implementation of large projects, a number of measures have been taken, including the setting up of a new Cabinet Committee on Investment (CCI) under the chairmanship of the Prime Minister. The Committee has been mandated to fast track large infrastructure projects. Debt funds have been set up to intermediate long-term resources for infrastructure projects. India has the second largest number of PPP projects in infrastructure in the world, the thrust on which is to be continued in the Twelfth Five Year Plan (2012-17). The authorities have recently accepted all the major recommendations of an Expert Committee on General Anti-Avoidance Rules (GAAR) for bringing about a greater clarity in the matter of taxation. The implementation of GAAR has been deferred till 2016. Efforts are also afoot to implement the Goods and Services Tax (GST) and Direct Tax Code (DTC) as early as possible. These and several other significant measures will help revert the economy on a high growth trajectory.

Global Factors

10. Having recognized the role of domestic constraints, it also needs to be underlined that the uncertain external environment played no less a role. The continued uncertainty in the global financial markets over the euro area sovereign debt concerns and the sluggish US recovery have led to anemic global growth and volatility in capital flows. The Indian economy is now highly integrated with the global economy - in fact, more integrated than some of the major advanced economies are. Therefore, the uncertain global macroeconomic situation directly impacts the Indian economy through various channels. In fact, staff's own estimates suggest that for every percentage point of lower global growth, India's growth is shaved off by 0.5 percentage point. As global growth has slowed down significantly, it has obviously impacted India's growth. At the same time, quantitative easing policies pursued by the major central banks have contributed to continued upward pressure on international commodity prices, which add to domestic inflationary pressures.

11. It also needs to be recognized that the slowdown is not unique to India alone. All the major economies, which experienced a robust rebound from the crisis of 2008-09, have witnessed a growth slowdown, although the extent of India's slowdown is somewhat higher for reasons outlined above. The growth has also been impacted due to cyclical factors. The Indian economy was quick to recover from the global financial crisis as it registered high growth rates of above 8 per cent in the 2009-10 and 2010-11. However, a cyclical slowdown set in during the second half of 2010-11 (April-March), again which was common across all the major economies of the world.

Short-term Outlook

12. The various measures announced by our authorities since September 2012 are beginning to improve the business sentiment. Various lead indicators suggest that the slowdown has bottomed out and the economy is headed towards higher growth, going forward. Reflecting the change in business sentiment, capital market conditions have improved. As a result, the interest of foreign institutional investors (FIIs) has also revived, resulting in improved capital flows. Headline inflation has moderated over the past two months. A significant decline in core inflation has been particularly comforting. This could possibly facilitate softening of the monetary policy stance, going forward. The RBI's Business Expectation Index for the October-December 2012 quarter, PMI for November and December and improvement in capital market conditions all suggest that the economy is poised for improved performance. The macroeconomic outlook in the near future is certainly more positive and the authorities expect that growth will be better than the staff's projections for 2013-14 and beyond.

Medium-term Outlook

13. Notwithstanding the recent growth slowdown, India's potential growth still remains intact as the underlying drivers of growth – high domestic savings, high investment, the demographic profile, a diversified and strong financial system, well-

functioning financial markets, and, overall, continued macroeconomic and financial stability – remain in place. Accordingly, long-term productive capacity and potential have not been much affected. In this regard, staff's estimates of potential growth seem to focus on the very near-term growth prospects of the economy and, therefore vary annually and are sensitive to choice of methodology. However, potential growth is a medium to longer-term concept that reflects underlying structural trends rather than cyclical variations and year-to-year shifts and events.

14. Recent structural reforms introduced by the authorities, and as outlined above, will help the economy return to its high growth trajectory. Our authorities recognize that high growth is essential for reducing India's poverty on a sustained basis. The percentage of the population below the poverty line declined at the rate of 1.5 percentage points every year in the period 2004-05 to 2009-10, twice the rate at which it declined in the previous period 1993-94 to 2004-05. Despite this impressive performance, however, a large proportion of population is still below the poverty line and our authorities are determined to bring that down further. Accordingly, as set out in the Draft 12th Five Year Plan document released recently, the economy is projected to grow at about 8.0 per cent per year during 2012-17 based on successful policy interventions at multiple leverage points which will generate virtuous cycles.

Monetary and Exchange Rate Policies

15. Inflation in India has been a cause of significant concern. Unlike several other emerging market economies, inflation in India has remained high and persistent during the last three years. Inflation has been driven by all the three major groups, viz., food, fuel and core. Food inflation has generally been volatile with large swings in the prices of certain food items such as fruits and vegetables. A major driver of food inflation has been protein-rich items. This reflects the changing consumption pattern due to rising income levels as also rising input costs on account of increase in wages. Recently, there has also been a spurt in cereal prices. As noted above, elevated oil and other international commodity prices on the back of quantitative easing policies in advanced economies added to domestic inflationary pressures. However, latest data suggest that inflation has begun to moderate. More importantly, core inflation has moderated significantly. In view of stabilizing global oil prices, the inflation dynamic, going forward, is expected to be more favorable.

16. While the wholesale price inflation is the headline indicator of inflation, the Reserve Bank makes use of an array of indicators to assess the underlying inflationary pressures, including movements in various consumer price indices, GDP deflator and inflation expectations surveys. However, in the Indian context, there are significant limitations of relying solely on consumer price indices for the conduct and formulation of monetary policy in view of the large weight of food items in the consumer price indices, over which monetary policy has limited direct effect. Moreover, in view of limited data points, it is not possible to use the new series as a measure of headline inflation. The authorities, will, therefore, continue to use the new series along with other indicators, as hitherto. Staff have made a suggestion that the RBI could make rolling one-year

projections of inflation. Uncertainty about the patterns and magnitude of seasonal effects such as monsoon complicates the generation of rolling projections. Such projections, if therefore made, could undermine the credibility of the RBI. In this context, it is relevant to note that, as the Reserve Bank has consistently articulated in its policy statements, the conduct of monetary policy continues to be conditioned by the need to contain perception of inflation in the range of 4.0-4.5 per cent, in line with the medium-term objective of 3.0 per cent inflation consistent with India's broader integration into the global economy.

17. Staff have made a suggestion that the debt limits for FIIs be raised, particularly in view of recent relaxation in external commercial borrowing (ECB) limits and also on the ground that FIIs will bear the forex risk. The authorities keep revising these limits periodically based on several considerations. However, given the wide interest rate differential between India and the major advanced economies, the authorities exercise caution while effecting revisions in these limits.

Financial Policies

18. The financial sector remains well-capitalized and has been contributing to growth in India. Prudent macroeconomic and financial policies have helped maintain financial stability in the Indian economy over the past two decades on a consistent basis, including in the period since 2007 when major advanced economies have seen a high degree of financial instability. Although NPAs have risen in consonance with the cyclical slowdown, they are still at a low level. Banks remain adequately capitalized, with overall capital adequacy at 13.6 per cent. Insofar as the restructured standard advances becoming NPAs is concerned, it needs to be noted that restructuring is allowed only in those cases where the account is expected to become viable after restructuring. Restructured standard advances are only 5.9 per cent of gross advances and historical experience suggests that only a small fraction of such restructured standard assets become NPAs. Even in a scenario when 30 per cent of restructured standard assets become NPAs, the average Tier I ratio at 8.1 per cent remains far above the prescribed level of 6 per cent. Nevertheless, the authorities have increased provisions for restructured standard accounts.

19. India is among the first G20 countries to have developed Basel III compliant regulations. The authorities are committed to keep all the public sector banks (PSBs) financially sound and healthy so as to ensure that the growing credit needs of our economy are adequately met. Full implementation of Basel III by 2018 could necessitate government cumulative capital injections in the PSBs of about 1 per cent of GDP. Although the amount looks large, it will be spread over the next six years. In this context, it may be noted that early this month the authorities decided to infuse capital of the order of Rs. 125 billion in public sector banks during the year 2012-13 to maintain their Tier-l CRAR at comfortable level so that they remain compliant with the stricter capital adequacy norms under Basel III.

20. Staff favor a lower statutory liquidity ratio (SLR), currently at 23 per cent, on the ground that it is crowding out private sector investment. At present, however, banks'

actual holding of SLR securities is above the statutory requirement, which would suggest that the SLR is not crowding out private investment. In this context, it is relevant to note that, first, the SLR holding of banks has been brought down over time from 38.5 per cent of net demand and time liabilities of banks in the early 1990s to 23 per cent at present. Second, the SLR securities are issued by the government at market-determined interest rates. Third, the holding of high-quality, highly liquid government bonds has strengthened banks' balance sheets and helped banks to better cope with financial stress situations by providing them with greater access to liquidity through a special window in the RBI. The financial stability enhancing role played by the SLR is thus important. It is, therefore, intriguing that the staff recommend the reduction in the SLR when it is now widely recognized that there is a need to boost the liquidity buffers of banks.

Conclusions

21. India's growth has slowed down and the Indian economy is facing some challenges. Having said that, however, recent developments are comforting. Inflation is beginning to moderate. A significant decline in core inflation is particularly encouraging. The authorities have initiated measures to reverse the negative sentiment and address supply side concerns. The authorities are also committed to contain the fiscal deficit. They have not hesitated to take several politically sensitive measures, including adjustments in fuel prices. The various lead indicators suggest that the slowdown has bottomed out and growth prospects from hereon should only be improving. The improvement in domestic growth will also be contingent on the global economic outlook, which still remains uncertain and subject to a number of downside risks as indicated in the January 2013 WEO Update. Notwithstanding the recent slowdown, India's medium to long-term growth prospects continue to be strong. Several measures taken by our authorities will help overcome various supply constraints, encourage fresh investment and revert the economy to a high growth trajectory.