June 2009
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India: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for India

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 2008 Article IV consultation with India, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 20, 2008, 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 January 22, 2009. 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.

- A staff statement of February 6, 2009, updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 6, 2009, discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for India.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INDIA

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with India

Approved by Kalpana Kochhar and Tamim Bayoumi

January 22, 2009

- **Discussions:** Delhi, December 8–14 and 18–20, 2008; Mumbai, December 14–18, 2008.
- **Staff team:** K. Kochhar (head), H. Oura, L. Papi, M. Saxegaard, P. Topalova (all APD), S. Peiris (MCM), and S. Panth (Senior Resident Representative). A. Simone (FAD) joined the first half of the mission in Delhi and A. Richter Hume contributed from headquarters.
- **Past advice:** The 2007 Article IV consultation was concluded on January 23, 2008. In recent years, the IMF and the authorities have generally agreed on policy priorities needed to sustain rapid, inclusive growth, with an emphasis on broader and deeper financial markets, fiscal consolidation, an enhanced monetary framework, and the removal of structural bottlenecks.
- **Focus of the consultation:** Implications of and policy response to the global crisis.
- **Selected Issues Paper:** corporate vulnerabilities; causes and consequences of capital flows to India; nonlinearities in exchange rate pass-through; and India's experience with fiscal rules.
- **Exchange rate regime:** Managed float. India is an Article VIII country, but maintains restrictions subject to approval under Article VIII.
- **Outreach:** Staff seminars at the Reserve Bank of India, the Ministry of Finance, and think tanks.
- **Economic statistics:** Adequate for surveillance purposes, but weaknesses remain.

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I. Staff Appraisal and Summary

Like most countries in the world, an increasingly globally integrated India will not be spared significant spillover effects from the present crisis. Its financial markets have sold off considerably and external funding for banks and corporates, which has risen in importance in recent years, has been sharply curtailed, thus jeopardizing investment and growth. The global crisis also coincides with a turning of the growth and credit cycles in India.

India's growth is likely to slow sharply. High frequency indicators already signal a broad-based and marked slowdown in activity. From an average of 8¾ percent in the past five years, growth is projected to fall to 6¼ percent in 2008/09 and 5¼ percent in 2009/10, with investment driving the slowdown. Stimulus measures and a good harvest should support consumption somewhat. Weaker domestic demand should reduce import growth, partly offsetting contracting exports. The current account deficit is projected at about 3 percent of GDP in 2008/09 before narrowing to 1½ percent of GDP the following year aided by lower oil prices. Inflation is anticipated to drop to below 3 percent by March 2009 and to an average of 2 percent in 2009/10 due to the collapse in commodity prices and softer domestic demand.

Reflecting the global economic situation, the uncertainty surrounding the forecasts is unusually large with still significant downside risks. The latter stem mainly from a protracted drought of credit and anemic world growth, as well as uncertainty of the outlook. Negative feedback loops between external shocks and domestic vulnerabilities and between the deteriorating corporate sector and the financial system could be strong. The main source of upside risk would be from a larger impact on growth of the stimulus measures.

Policy Response

The authorities have already taken numerous welcome measures in response to the crisis. The Reserve Bank of India (RBI) was quick in reversing its policy stance and the reductions in interest rates, the cash reserve ratio (CRR), and the statutory liquidity requirement (SLR) together with stepped up open market operations were fully warranted. The authorities should also be commended for continuing to liberalize the capital account and for reiterating their commitment to financial sector reforms.

Given the uncertainty and downside risks, the policy response needs to continue to be flexible, but disciplined. With public debt at 80 percent of GDP, monetary and structural policies will need to carry the weight of the policy response, and the limited fiscal room focused on high priority infrastructure investment and on banking system recapitalization. The priorities are (i) ensuring adequate financing to the real economy while protecting financial stability; and (ii) facilitating corporate restructuring to ensure viable firms can emerge stronger and unviable ones are quickly dealt with. Recognizing that some painful adjustment is inevitable, priorities already identified in the medium-term reform agenda should determine the focus of policies. Such a strategy will give India—whose medium- and long-term advantages remain intact—the best chance to benefit from an eventual return of capital flows. As in all countries, protectionist trade measures should be resisted, as the global economy, including India, will bear the cost of the resulting decline in global trade.

Keeping Credit Flowing While Preserving Financial Stability

With the balance of risks having shifted decisively from inflation to growth, there is more room for interest rate cuts and liquidity provision. Even after the most recent reduction in policy rates, real interest rates based on expected inflation remain higher than a few months ago. Hence, policy rates could be cut further. Although interest rates may have a limited impact as long as the policy transmission mechanism is muted, they would still provide a powerful signal and contribute to easing credit conditions. The RBI's measures have addressed the acute liquidity shortage that occurred in late 2008. If a liquidity crunch were to resurface, further reductions in the CRR and repurchasing market stabilization bonds can be relied upon. If these steps were to prove insufficient, consideration could be given to broadening collateral accepted at the RBI's repo window and providing liquidity over longer horizons as done by several countries.

Exchange rate policy needs to be consistent with ensuring sufficient liquidity in the system. The exchange rate has been managed flexibly in recent months. However, as reserves have fallen substantially, they would be best conserved for limited provision of foreign exchange to relieve concerns about external financing, for example along the lines of what Brazil and Korea have put in place, while letting the exchange rate take the brunt of the adjustment. Banks' and corporates' balance sheets appear more sensitive to interest rate than exchange rate risk.

Based on headline indicators India's financial system compares favorably internationally, but rising credit risk and liquidity pressures are putting it under strain (though information gaps make a definitive assessment difficult). Banks are well capitalized and have low nonperforming assets (NPAs). Nevertheless, the current downturn is likely to lead to a substantial increase in NPAs, and liquidity pressures could re-emerge. Nonbank financial institutions have already shown signs of stress.

International experience suggests that loss recognition and bank recapitalization are the measures most likely to be effective in restoring the flow of credit to the economy. A priority for India in the current circumstances is to identify the capital needs of the banking system by subjecting it to multifactor stress tests that take account of feedback loops between the real and financial sectors—the extent of which have been greatly underestimated in several countries. Key steps include (i) avoiding masking the true extent of the bad asset problem and the underlying capital position of financial institutions; (ii) providing incentives for early loss recognition; (iii) identifying capital needs and recapitalizing banks early; and (iv) enhancing existing frameworks to dispose efficiently of impaired assets and to promote corporate restructuring. Information on unhedged foreign exchange exposures and derivatives should be disclosed to allay market concerns, as done by Mexico recently.

Government-assisted refinance and credit guarantees could be an additional option to spur bank lending. Building on the refinance schemes already existing in India, especially those aimed at funding infrastructure, the government could expand such activities, provided transparency and appropriate assessment and pricing of risks are ensured. Examples of explicit risk sharing mechanisms are offered by the Hong Kong SAR and the U.K. credit guarantee programs.

In addition, the authorities' own financial reform agenda needs to be rapidly advanced to ensure adequate credit to corporates from sources other than the banking system. The domestic banking system should not be expected to fully compensate for the decline in other sources of corporate funding and to finance the needed higher infrastructure investment. Instead, developing the corporate bond market—as recommended by the Parekh, Patil and Rajan committees—and, further capital account liberalization (e.g. lifting all interest rate caps and minimum maturity requirements) could help ease the current funding crunch for corporates and position India well for when capital inflows pick up. Improving banking system efficiency also remains an important objective.

Finally, preparing for a possible deterioration in financial conditions would be advisable. These exercises should aim especially at strengthening cross-institutional coordination and reviewing intervention frameworks. Facilities to supplement international reserves could also be considered.

Corporate Sector Restructuring Is a High Priority

The potential substantial rise in corporate distress would be better addressed through corporate debt and operational restructuring, rather than direct public sector intervention in specific firms or sectors. Although corporate balance sheets seem healthy, the sharp changes in financial and economic conditions are likely to put them under considerable strain. Implementing the Rajan Report recommendations to improve the bankruptcy law and enhance out-of-court restructuring mechanisms, and passing the Companies Bill, would represent major positive steps in dealing with corporate distress.

Limited Role for Fiscal Policy

High government debt and deficits limit the room for maneuver: if further stimulus is deemed necessary, it should be combined with reforms that ensure medium-term debt sustainability. The stimulus implemented this year is already sizable, and with public debt at about 80 percent of GDP, further substantial expansion in the deficit risks backfiring, as concerns about debt sustainability could raise interest rates. The limited room should be conserved for high quality infrastructure investment and bank recapitalization if needed. In addition, lower commodity prices offer an opportunity to reform the fuel subsidy system, which would clearly signal the government's commitment to fiscal discipline.

Beyond the current downturn, fiscal consolidation continues to be a key priority as public finances remain India's Achilles' heel. The medium-term fiscal adjustment should be anchored in a fiscal rules framework centered on a debt target and buttressed by comprehensive expenditure reforms, which could play an important role in promoting fiscal consolidation.

It is proposed that the next Article IV consultation with India take place on the standard 12-month cycle.

II. Context: First International Financial Crisis Since India Went Global

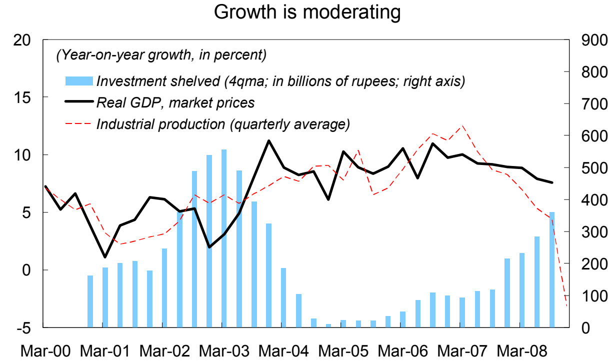
1. **India faces the first global economic crisis since emerging as an economic powerhouse.** Reaping the benefits of reforms, macroeconomic stability, and a supportive external environment, India achieved growth of 8¾ percent on average during 2003/04-2007/08, with a significant reduction in poverty.[1] The surge in investment, the key driver of growth, was financed by rising private and public savings, but increasingly also by foreign capital as links with the rest of the world grew (Figure 1). Now the global crisis is hitting India's financial markets and is sharply curtailing external funding, jeopardizing investment and growth.

2. **The consultation focused on the implications of the global crisis for India and the needed policy response.** While the response needs inevitably to be focused on dealing with short-term pressures, these should be set in the context of the longer-term challenges and reforms that India needs to support strong and inclusive growth. In particular, given the country's massive investment needs, it is essential that scarce fiscal resources be focused on jumpstarting infrastructure investment, together with further opening up to foreign inflows and developing the domestic corporate bond market to augment the needed financing. At the same time, reforms to reduce subsidies and other unproductive expenditure will go a long way to provide assurances of the government's commitment to fiscal consolidation.

III. Recent Developments: Global Headwinds Exacerbate Domestic Weaknesses

3. **The global financial crisis is exacerbating a cyclical downturn that was already underway.** GDP growth softened to 7.8 percent (y/y) in April–September, pulled down mainly by weaker investment and private consumption (Figure 2). Data for the October–December quarter (including trade, industrial production, vehicle sales, and business confidence) suggest that growth has already slowed sharply, and leading indicators signal deeper and broader-based weaknesses ahead.

Growth is moderating



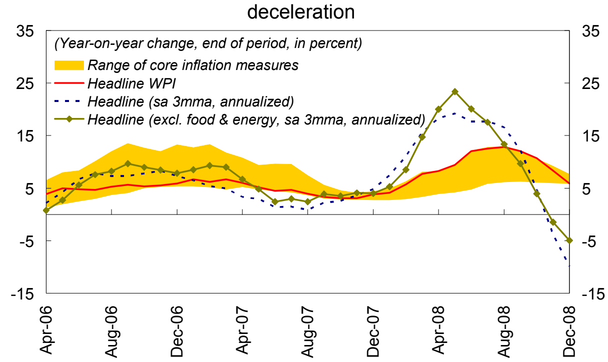
Sources: CEIC Data Company Ltd.; CMIE; and Fund staff calculation.

4. **Inflation is decelerating rapidly after rising markedly in mid-2008.** Headline inflation (WPI) surged to almost 13 percent (y/y) in August 2008, but dropped to below 6 percent by December. Commodity prices were the drivers of the initial inflation spike, with

[1] The fiscal year starts in April.

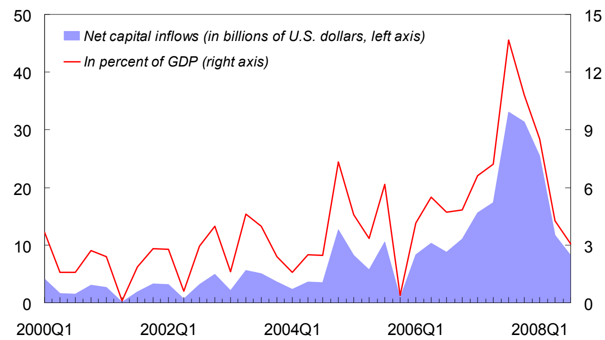
considerable second-round effects on other goods. However, the inflation momentum—measured by core inflation—is now dissipating rapidly.

Inflation has peaked; core measures indicate likely further deceleration



Sources: CEIC Data Company Ltd.; and Fund staff estimates.

Capital flows have fallen sharply



Sources: CEIC Data Company Ltd; and Fund staff calculation.

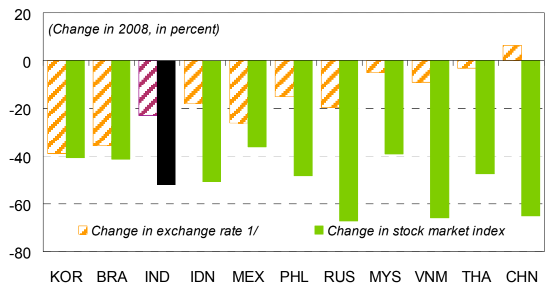
5. **High commodity prices and the global turmoil have weakened India's external position.** With the oil import bill rising by over 50 percent (y/y), the current account deficit widened to 3¾ percent of GDP in April–September compared to 1½ percent of GDP in 2007/08 even though exports of goods and services held up well. October and November saw exports contracting by over 10 percent, partly owing to disruptions in trade credit, but softer import growth kept the trade deficit in check. Capital inflows in H1 2008/09 fell to US$20 billion (3½ percent of GDP), less than half of those in the same period a year earlier. While foreign direct investment (FDI) has been strong possibly owing to projects launched before the onset of the crisis, external commercial borrowing (ECB) disbursements in April–September were less than half of their 2007/08 levels and external funding became significantly more expensive (Figure 3). Portfolio outflows amounted to US$9 billion in April–December, with an outflow of over $4 billion in October alone and a mild recovery since then.

6. **Like in most countries around the world, the global financial crisis has hit Indian assets hard.** Amid heightened volatility, the stock market decline was led by foreign investors' sales, which brought price-to-earnings (P/E) ratios broadly in line with the average for emerging markets (Figure 3). Financials and real estate suffered the steepest sell-offs, reflecting earlier sharp increases in leverage and asset prices. Property prices are reported to be falling, especially in the commercial and high-end segments. The 23 percent depreciation of the currency versus the U.S. dollar in 2008 (11 percent since end-August) was one of the largest in Asia, despite RBI intervention.[2] From a historical peak of US$315 billion in May 2008, foreign exchange (FX) reserves have declined to US$255 billion (January 2, 2008),

[2] The nominal effective exchange rate depreciated by over 14 percent in 2008.

with a US$39 billion drop in October alone (half of which was due to valuation losses). Equity prices have recovered marginally since October.

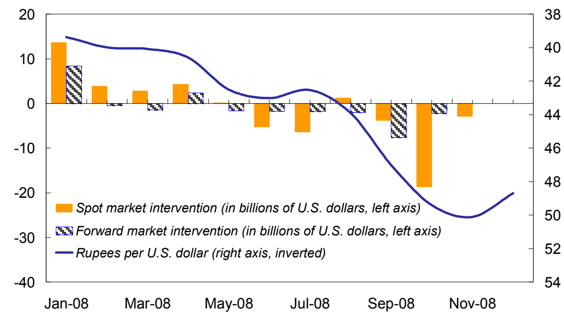
The global crisis has hit India's currency and equity markets



Sources: Bloomberg L.P.; and CEIC Data Company Ltd.

1/ Exchange rate is defined as national currency per U.S. dollar. Data as of December 30, 2008.

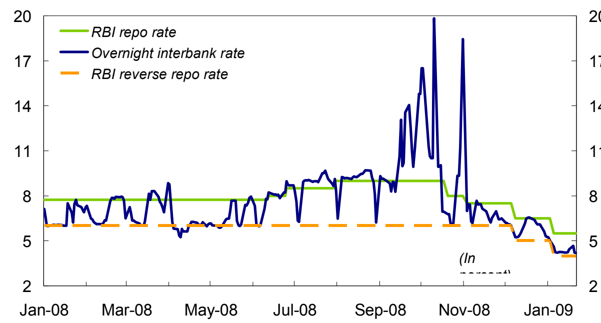
The rupee has depreciated despite heavy central bank intervention



Sources: Reserve Bank of India; Bloomberg L.P.; and Fund staff estimates.

7. **In response to central bank measures liquidity pressures in the domestic money market have eased since October, but credit conditions remain tight (Box 1).** While overnight rates have come down in line with policy rates, TED, overnight index swaps, and commercial paper spreads have eased only slightly. Moreover, credit availability is constrained. Bank credit growth accelerated through October, reflecting in part the shift in corporate demand to domestic banks following the drying up of other sources of financing. However, since then it has decelerated sharply, in particular in momentum terms (with growth negative on a month-on-month, seasonally adjusted basis). Financing from nonbank financial institutions is constrained by redemption pressures and poor asset performance.

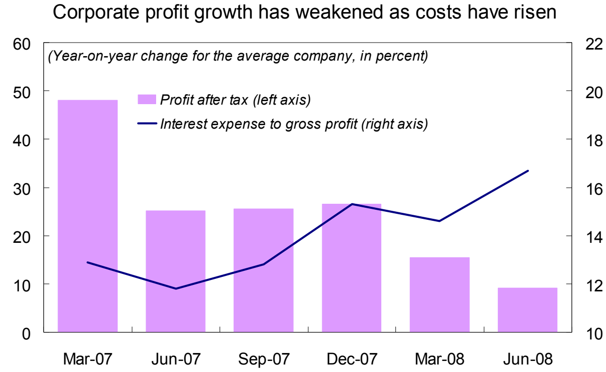
The call rate has been volatile, but has remained within the policy rate band since early November



Source: Bloomberg L.P.

8. **After several years of rapid expansion, buoyant profits, and improving balance sheets, India's corporate performance is deteriorating appreciably.** Indian corporates' balance sheets were healthy as of March 2008.[3] However, high

Corporate profit growth has weakened as costs have risen



Source: CEIC Data Company Ltd.

[3] See Chapter I of the accompanying Selected Issues Paper for an analysis of corporate vulnerabilities.

Box 1. Measures Adopted in Response to the Crisis since September 2008

Measures to increase rupee liquidity

- **Cut in policy rates.** Repo rate by 350 bps to 5½ percent and reverse repo rate by 200 bps to 4 percent.
- **Cut in cash reserve ratio (CRR).** By 400 bps to 5 percent.
- **Cut in statutory liquidity requirement (SLR).** By 100 bps to 24 percent of net demand and time liabilities (NDTL).
- **Repurchase of market stabilization bonds.** About 0.3 percent of GDP re-purchased since end-September.
- **Term repo facility.** 14-day repo facility for banks to onlend to mutual funds, NBFCs, and housing financing companies (HFCs). Rs 600 billion (1.1 percent of GDP) available, at the repo rate, through June 2009. SLR reduced by 1½ percentage points for banks using this facility.
- **Refinance facilities**. For banks up to 1 percent of NDTL (0.6 percent of GDP), at repo rate, up to 90 days, through June 2009. Additional facilities (0.3 percent of GDP, terms as above, through March 2010) for the Small Industries Development Bank, the National Housing Bank, and the Export and Import Bank. Limit on the RBI's export credit refinance facility (at repo rate) raised from 15 to 50 percent of bank's outstanding export credit.
- **Other measures.** Select oil bonds allowed as collateral in RBI repos. Special purpose vehicle to buy up to Rs 250 billion (0.5 percent of GDP) in investment grade paper from NBFCs.

Measures to increase FX liquidity

- **FX swaps**. For Indian banks with foreign branches or subsidiaries to access FX swaps, up to three months, through June 2009; for entities with bulk FX requirements through their banks. Reactivation of RBI's special facility for conversion of oil bonds into FX.

Measures to increase credit delivery

- **Trade credit.** Period of entitlement for concessional rates on rupee export credits increased.
- **Priority sector lending.** Bank loans to HFCs for small housing loans classified as priority. Benefits for SMEs under the Credit Guarantee Scheme enhanced (coverage amount doubled, and guarantee cover increased from to 50-85 percent).
- **Regulatory forbearance.** Extension of existing special regulatory regime on asset classification (which allows loan assets in high-priority sectors that have been restructured quickly to remain in the pre-restructuring asset classification category) to commercial real estate and to undersecured working capital term loans. Special regime also extended to second restructuring of all qualifying loans (though not to commercial real estate), and to housing loans with a maturity above 10 years (although additional risk weight of 25 percentage points introduced at time of restructuring).
- **Provisioning requirements.** For standard assets reduced to a standard level of 0.4 percent for real estate, personal loans, capital markets, and select NBFCs.
- **Risk weights.** Reduced to 100 percent for commercial real estate assets, claims on select NBFCs, and asset financing companies.
- **Other measures.** Credit targets for public sector banks increased for January-March 2009. Public sector banks to provide a line of credit to NBFCs for purchase of commercial vehicles.

Box 1. Measures Adopted in Response to the Crisis since September 2008, Concluded

Measures to encourage capital inflows

- **Trade credit. A**ll-in-cost ceiling raised by 75–125 bps, depending on maturity.
- **Portfolio investment.** Removal of curbs on foreign issuance of equity derivatives (so-called P-notes) imposed in October 2007. Limit on FII holdings of corporate bonds raised from $3 billion to $15 billion, and of government bonds from $3 billion to $5 billion. Restriction on allocation of FII investments across equity and debt lifted.
- **External commercial borrowing (ECB).** Increase in borrowing limits per company and for the economy as a whole (from $22 billion to $35 billion). All-in cost ceiling removed for ECBs under the approval route (through June 2009) and raised for ECBs under the automatic route. Sectoral restrictions on ECBs relaxed.
- **Nonresident Indian deposits.** Cap on interest rates increased by 175 bps.
- **Other measures.** Limit on bank borrowing from overseas branches raised from 25 percent to 50 percent of unimpaired Tier I capital or US$10 mn, whichever is higher.

Fiscal measures

- **Tax**. Central VAT cut by 4 ppts (excluding petroleum products; cost of 0.2 percent of GDP). Reinstatement of import duties on selected products. Accelerated depreciation of 50 percent for vehicles purchased in January-March 2009.
- **Spending.** 0.4 percent of GDP for housing, infrastructure, irrigation, textiles, rural employment, and social assistance schemes. Limit on market borrowing by states to finance capital expenditure raised by 0.5 percent of states' GDP.
- **Promotion of exports.** Interest subsidy of 2 percent introduced for export credit for labor intensive exports (until March 2009). Enhancement of duty drawback benefits.
- **Public sector bank recapitalization:** over next two years, 0.4 percent of GDP.
- **Off-budgetary measures.** India Infrastructure Finance Company Limited authorized to raise (in debt financing) Rs 400 billion (0.8 percent of GDP) over the next 18 months.

commodity prices and interest rates pushed up firms' costs and squeezed margins in 2008. Some importers and firms with large foreign exchange liabilities, incurred partly to finance overseas acquisitions, are also suffering losses from the rupee depreciation. Corporate profit growth fell to 9 percent (y/y) in the April–June quarter from about 25 percent in 2007. Preliminary results for the July–September quarter were weaker, and the 22 percent fall in the December advance corporate tax payments does not bode well for the profit outlook.

9. **Mirroring global trends, markets are taking a negative view of India's financial institutions' health.** Banks, which dominate the financial system, have seen their share prices fall sharply. Their credit default swap (CDS) spreads and default probabilities have risen dramatically despite a more positive assessment by bank analysts and credit rating agencies. A large private bank suffered a modest deposit run in late September that was quickly contained after official reassurances that the bank was sound. Third quarter results still point to relatively robust profit growth for most banks, but NPAs are rising. Furthermore, mutual funds (MFs) have faced significant redemptions (nearly 15 percent of assets in September) mainly due to corporates' withdrawals, but the situation has stabilized recently. Finally, nonbank finance companies (NBFCs) are reported to have seen a dramatic increase in borrowing costs.

10. **The budget performance has deteriorated substantially this year.** During April–November 2008, tax revenues grew by 15 percent (y/y), but collections slowed significantly in recent months as economic activity weakened and stimulus measures, notably a 4 percentage point cut in the central VAT, took effect (Figure 4). In the same period, spending also rose rapidly driven by a soaring subsidy bill, an agricultural loan write off, a 21 percent civil servant wage increase, and the strong off-take of a rural employment scheme (NREG). With the two supplementary budgets (announced in October and December) approving additional on-budget spending of 2.7 percent of GDP including to fund the stimulus packages (0.6 percent of GDP), and subsidy-related bonds of 1.6 percent of GDP, the deficit is set to exceed the budget target by a substantial amount. As of March 2008, public debt was 80 percent of GDP, roughly unchanged from end-2007 (see Annex I).[4]

IV. Outlook: A Marked Slowdown with High Uncertainty and Downside Risks

11. **Growth is set to slow markedly in this fiscal year and next.** From 9 percent in 2007/08, growth is projected at 6¼ percent in 2008/09 and 5¼ percent in 2009/10, slightly below market forecasts.[5] With nonagricultural growth falling by 4 percentage points, the

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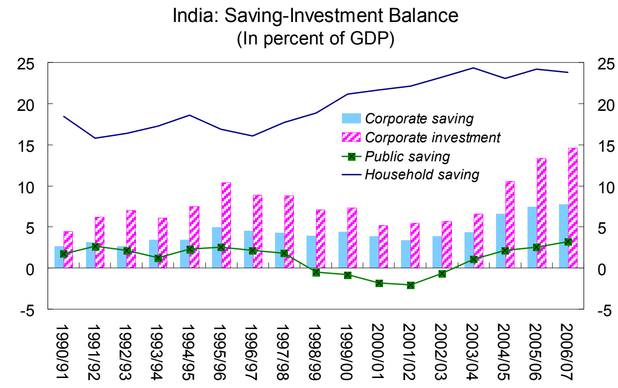
[4] These subsidy-related bonds are not included in the authorities's definition of the central government budget deficit, while they are included in the staff's definition.

[5] While the Mumbai attacks, which took place in November 2008, might reduce tourism, it is difficult to disentangle their impact from the broader slowdown.

envisaged slowdown is sharper than that at the time of the 2001 global recession when nonagricultural growth slowed from 7.8 percent in 1999/2000 to 5.9 percent in 2000/01. The current global crisis far exceeds the extent of past recessions and India is significantly more integrated with the rest of the world. As in 2001, investment is likely to weaken substantially via the financing and confidence channels combined with softer demand (Box 2). Moreover, declining corporate profitability and savings will likely reverse the past years' upward trend in domestic savings that enabled investment-led growth to take off. Stimulus measures and a good harvest should support consumption somewhat, but the growth impact of the recently approved fiscal measures could be limited by implementation capacity constraints and only partial pass through of tax reductions to prices. Export growth is projected to fall, but weaker domestic demand should also reduce import growth, keeping net exports' contribution to growth broadly stable.



Sources: CEIC Data Company Ltd.

12. **Inflation is expected to fall sharply.** With commodity prices receding and slackening demand curbing wage growth and pricing power, inflation is anticipated to drop to below 3 percent y/y by March 2009 and to an average 2 percent in 2009/10.

13. **The overall balance of payments is projected to be in deficit this year and next.** The current account deficit is projected at below 3 percent of GDP in 2008/09, before narrowing to 1½ percent of GDP next fiscal year due to lower oil prices and softer domestic demand, and as the rupee depreciation buffers the effect of slowing external demand on exports. Although it is difficult to predict when investor risk appetite will return, portfolio and debt capital flows are unlikely to recover appreciably at least until late 2009.[6] FDI flows, beyond projects already in the pipeline, are also expected to slow and are unlikely to pick up before the recovery in advanced economies materializes.[7]

14. **Reflecting the global economic situation, the margin of uncertainty surrounding the forecasts is unusually large with still significant downside risks.** The main risks stem from global spillovers. A protracted drought of credit and anemic world growth would stunt

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[6] See Chapter II of the accompanying Selected Issues Paper, which discusses the determinants of capital flows to emerging markets and India in particular.

[7] The recently disclosed accounting scandal involving Satyam, one of India's largest IT companies, adds to the uncertainty of the outlook for foreign direct investment and for the IT and outsourcing sector.

Box 2. India—Spillover Channels of the Global Financial Crisis to India

The global crisis is affecting India mainly through the following channels.

- **Lower investment and growth resulting from reduced availability of financing, higher funding costs, and deteriorating sentiment**. By 2007/08, the share of Indian corporates' funding from external sources had risen to 25 percent, while equity issuance accounted for an additional 10 percent. Corporate profitability is expected to deteriorate considerably, thus reducing firms' internal sources of funding. Weaker demand and uncertainty about the outlook are also depressing investment.

The contribution from foreign financing has risen significantly

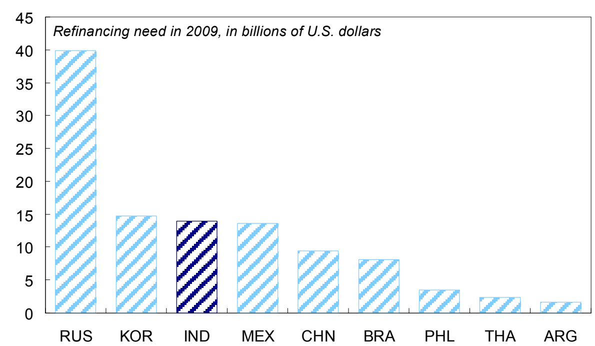
In percent of total funds

	Foreign Direct Investment	Foreign Borrowing	Equity Issuance	Bank Credit	Retained Earnings
2003–04	11.8	-7.9	13.8	10.4	71.8
2004–05	6.8	5.9	7.2	27.9	52.3
2005–06	8.3	2.4	5.8	26.9	56.6
2006–07	14.7	10.8	5.0	21.8	47.7
2007–08	15.4	10.5	10.2	20.6	43.3

Sources: Securities and Exchange Board of India, Reserve Bank of India and Central Statistical Organization, India.

- **Some firms and sectors could face dollar funding problems**. India's private sector is exposed to a deterioration in investor sentiment mainly in the equity market, where foreigners hold about US$53 billion in shares, a third of the free float. In addition, some large Indian firms are facing significant near-term FX refinancing pressures. The amount of foreign borrowing (bonds and loans) by Indian banks and corporates falling due in 2009 is the third largest among emerging markets. Moreover, the net asset position of Indian banks and corporates vis-à-vis BIS reporting banks has deteriorated rapidly over the last two years, and has become negative. The availability of trade credits was also sharply reduced in the fall of 2008 in line with global developments.

India's refinancing needs are high among EMs



Source: J.P. Morgan.

India's international investment position has turned negative 1/

In billions of U.S. dollars

Assets	**378**
Direct	48.2
Portfolio	0.7
Other	16.6
Reserve	312
Liabilities	**427**
Direct	120
Portfolio	108
Equity	87
Debt	21
Other	199
Trade credits	47.3
Loans	107
Currency & deposit	43.6
Other	1.85
Memo items	
External commercial borrowings	62
Multi- and bilateral loans	58
Total external debt	220

Source: Reserve Bank of India.

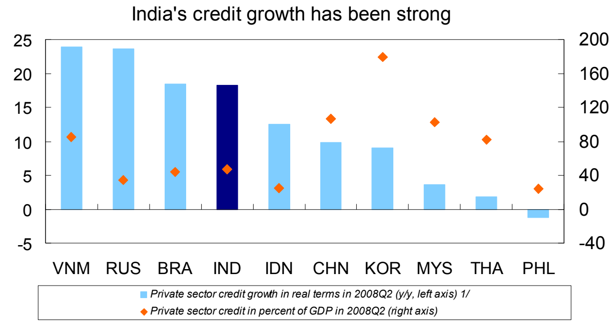
1/ As of June 2008.

- **Credit quality could deteriorate substantially, which could lead financial institutions to cut credit**. India's credit expansion has been fairly strong compared to other emerging markets. Maturation of the domestic credit cycle and an expected deterioration of corporates' financial situation (especially SMEs and real estate firms) are expected to affect banks' performance adversely.

- A **weaker rupee.** FX debt is estimated to amount to 20–30 percent of total corporate debt. Continued depreciation would especially affect those firms that have borrowed in FX without hedging, with banks in turn exposed to the deterioration in the financial health of their borrowers. It could also entail higher cost of finance externally and domestically. A depreciation would also increase the current account deficit in the short run.

Box 2. India—Spillover Channels of the Global Financial Crisis to India, Concluded

Despite these spillovers and vulnerabilities, there are risk-mitigating factors.

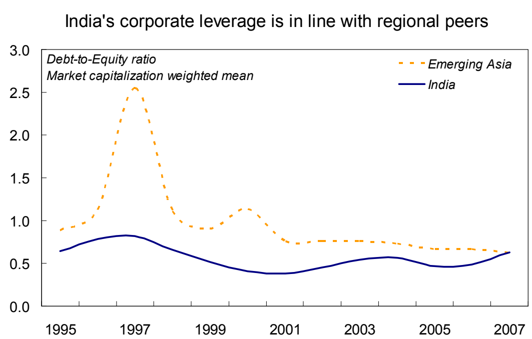


Sources: CEIC Data Company Ltd; and Fund, *World Economic Outlook*, *International Financial Statistics* and staff calculations.

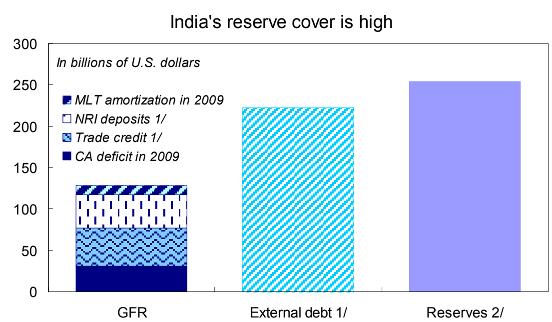
1/ Data for the Philippines pertain to end-2007. Except for China nominal credit to the private sector is deflated by the quarterly GDP deflator. For China, the consumer price index is used.

- **Low levels of external debt and strong reserve coverage**. India's gross external financing requirement and total external debt are low[1] and more than covered by reserves (50 and 75 percent of reserves, respectively). Although it has increased recently, the leverage of nonfinancial firms is in line with regional peers.

- **Limited spillovers through trade**. A 1 percent slowdown in global growth is estimated to trim only 0.3 percentage point from India's growth. In addition, domestic demand explains almost all of India's recent growth.



Source: Fund, Corporate Vulnerability Utility.



Source: Country authorities; and Fund staff estimates.

1/ As of September 2008
2/ As of December 2008

- **Declining commodity prices should further lower inflation, narrow the current account deficit, and limit the fiscal burden of oil subsidies.** Declines in nonadministered oil prices should contribute to the moderation in inflation, leaving room for monetary easing. A US$10 decline in the oil price reduces the current account deficit by 0.4 percent of GDP and the cost of oil subsidies by 0.6 percent of GDP.

[1] The expected near-term refinancing need of Indian corporations is estimated at US$14 billion in 2009 (JP Morgan, based on international bond and loan issuance data).

investment, exports, and growth. Consumption could also be hit more, especially if job losses mount and consumer credit dries up. Also, given the high degree of uncertainty, policy trade-offs could become difficult to manage. Finally, the elections, due to take place by May 2009, could add to the policy uncertainty. The main source of upside risk would be from a larger than expected impact of the stimulus measures.

15. **Feedback loops between the financial and real sectors and between external shocks and domestic vulnerabilities could be strong.** As already unfolding in several countries, corporate difficulties will lead to increased delinquencies on bank loans, undermining financial stability and leading to capital deficiencies and lower credit growth, and in turn causing further difficulties for corporates. Slower growth would further depress foreign investor sentiment and capital flows. Flagging corporate profitability will lower tax revenues and worsen the fiscal position, which could drive up interest rates and India's risk premium, in turn squeezing corporate profits.

16. **Once the current downturn is overcome, India's inherent strong long-term fundamentals should prevail once again.** As the current risk aversion recedes, investors are expected to become more discriminating, which together with a reduced pool of investable funds entails much greater competition among emerging market countries to attract foreign capital. Against this, India's fundamental strengths—arising from its demographic advantage, well-developed institutions, and large potential domestic demand—remain intact and will likely be seen favorably by investors relative to countries more dependent on external demand.

Authorities' Views

17. **The authorities agreed that India is experiencing knock-on effects of the global crisis, but considered the staff's outlook too pessimistic.** They noted that like other developing countries, India is being affected mainly via the trade channels. They contrasted India's experience with that of advanced economies where "the contagion spread from the financial to the real sector, while in India, the slowdown in the real sector was affecting the financial sector, which in turn has a second-order impact on the real sector".[8] The authorities contended that the effects were mainly indirect and have been addressed by the measures taken, while noting that they stood ready to act swiftly in response to evolving circumstances, employing both conventional and unconventional measures. They expected 2008/09 growth at 7 percent. They emphasized the overall strength of domestic demand boosted by fiscal stimulus and substantial investment in infrastructure and argued that investment had been financed predominantly via domestic savings. While acknowledging the high uncertainty surrounding next year's outlook, they remained confident that once the situation stabilizes,

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[8] Governor Subbarao's speech at the Bankers' Club, Kolkata on December 10, 2008.

growth would return to the high trajectory of recent years. Overall, the authorities were cautiously optimistic, while agreeing that the main sources of risks were external.

V. Policy Discussions

18. **The policy discussions were conducted recognizing that policymaking the world over is in uncharted territory, and that, policy responses therefore should continue to be flexible, but disciplined.** The authorities have already taken numerous measures to address the crisis. Particularly noteworthy are the continued liberalization of the capital account and the renewed commitment to financial sector reforms exemplified by the decision not to ban shortselling of stocks and by the introduction of exchange-traded currency and interest rate futures. As the crisis spreads and deepens, priorities already identified in the medium-term reform agenda should determine the focus of policies, recognizing that some painful adjustment is inevitable. In addition, whenever government involvement is deemed necessary, it would be most effective in partnership with the private sector. If extraordinary measures are needed, an upfront announcement of an exit strategy would help avoid the perception that medium-term sustainability could be at risk. Reforms that would poise the economy for a stronger recovery should be implemented without delay, even if the near-term payoff may not seem large. With competition among emerging markets to attract foreign capital likely to be fierce when global capital markets normalize, strong fundamentals and policies will play a key differentiating role. With little fiscal room for further maneuver, the priorities are: (i) ensuring adequate financing to the real economy while protecting financial stability; and (ii) facilitating corporate restructuring so that viable companies can emerge stronger and unviable companies can be quickly and efficiently resolved.

Authorities' Views

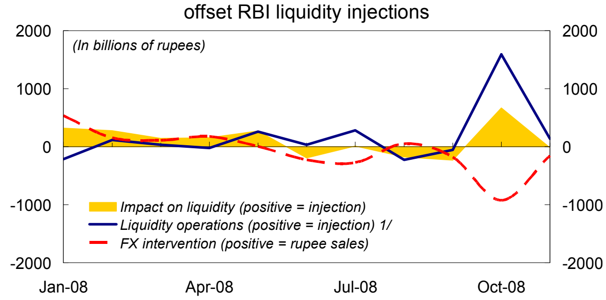
19. **The authorities emphasized that in the current circumstances it is not possible to have a precise roadmap for the policy response.** There were simply too many "unknown unknowns" and the measures necessarily needed to be partly reactive. They underlined their commitment to respond flexibly and pragmatically to the evolving situation to mitigate the impact of the crisis. While they did not share the staff's view of the centrality of enhancing corporate restructuring mechanisms at this juncture and saw greater room for fiscal stimulus, they agreed that the major challenge was to maintain the flow of credit to the economy while maintaining credit quality.

A. Keeping Credit Flowing While Maintaining Financial Stability: The Role of Monetary and Exchange Rate Policy

Background

20. **In the wake of the global financial crisis, the RBI quickly turned its focus to supporting growth and maintaining financial stability.** Until early September, monetary policy had been geared towards reducing inflation, with the policy rate and the CRR each raised by 125 bps between May and July. But as financial market conditions tightened, the RBI changed gears, implementing measures to ease liquidity—notably by cutting the CRR by 400 bps, the policy rate by 350 bps beginning in late October, and the SLR (see Box 1). However, because the RBI intervened aggressively, liquidity pressures persisted until early November. Since then, the decline in intervention, combined with additional liquidity measures, have eased these pressures significantly. Nevertheless, as the staff's outlook for the balance of payments suggests further outflows, liquidity strains could reemerge, and in turn could quickly threaten solvency. Markets expect the RBI to ease monetary policy further in the coming months.

Until October, large-scale foreign exchange intervention offset RBI liquidity injections



Sources: Reserve Bank of India; CEIC Data Company Ltd; and Fund staff estimates.

1/ Includes repo and open market operations (including in market stabilization bonds), change in central government deposits at the RBI, and impacts of changes in the cash reserve ratio and the statutory liquidity ratio.

21. **Financing conditions remain tight.** Overall financing to firms appears to have contracted, despite the substitution of domestic credit for other sources of corporate funding. Banks have become more reluctant to extend credit, especially to sectors to which lending had expanded rapidly in recent years, such as real estate, small- and medium-sized enterprises (SMEs), nonbank financial corporations, and consumers. The decline in credit supply reflects concerns about the outlook for the real economy, an uncertain funding environment, and the increased attractiveness of government securities due to the expectation of capital gains (on the back of further monetary easing). In light of these pressures, commercial lending rates have not fallen in line with the policy rate, and prime lending rates (PLR) are now in the range of 8–10 percent in

Nonbank financing for industry has fallen sharply

	H1 2007/08	H1 2008/09	Change (year-on-year)	Change (year-on-year)
	(In billions of rupees)			*(In percent)*
Bank credit	442	604	162	36.8
Flow from nonbanks to corporates	1,198	667	-531	-44.3
Domestic capital issues (bond and equity)	200	119	-81	-40.5
Issues of commercial paper	159	216	57	35.6
ADR/GDR	112	47	-65	-58.3
External commercial borrowing	727	286	-442	-60.7
Total	1,640	1,272	-368	-22.5

Source: Reserve Bank of India, "Macroeconomic and Monetary Developments: Mid-Term Review 2008¬09".

real terms based on expected inflation.[9] Although demand for credit is likely to decline, tight financing conditions are expected to persist into 2009: the slowing economy will further decelerate deposit growth, thus constraining the supply of bank credit, while nonbank financing, foreign financing, and domestic capital market activity are unlikely to revive any time soon. In addition, rising concerns about corporate sector health are likely to keep the cost of credit high.

Policy Response

22. **With the continued very sharp decline in inflation, there is room for further interest rate cuts.** Despite having reduced the policy rate by 350 bps since October, the real policy rate (based on projected inflation) has risen. While interest rates may have only a limited impact on credit growth in this uncertain environment, further rate cuts could act as an important signal to the market about the outlook for inflation. They would also reduce the cost of funds for financial institutions and their customers (to the extent that they are passed on) and reduce debt service costs for the government.[10] In addition, lowering the reverse repo rate would reduce incentives for banks to deposit funds at the RBI. Moreover, the impact of further rate cuts on capital flows and the exchange rate would likely be limited: the risk that lower interest rates may prompt outflows is small—interest rate differentials have actually widened in favor of India and an improved financing (and growth) outlook could spur inflows. In any case, the exchange rate pass through would likely be quite small given soft demand conditions.[11]

23. **The numerous measures taken by the RBI to boost liquidity and its preparedness to do more in the event of renewed pressure are welcome.** The reductions in the policy rates, the CRR, and the SLR were fully warranted. If liquidity were to tighten again, the RBI has a significant stock of "captured" liquidity that could be released: market stabilization bonds could be repurchased; the CRR and SLR could be lowered further; and all subsidy-related bonds issued by the government could be made eligible for repos with the RBI.[12] In addition, to ensure the availability of liquidity over the longer horizon, the RBI

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[9] The PLR reported by the RBI averaged 12–14 percent in November, but some private banks have reported PLRs of 14–17 percent.

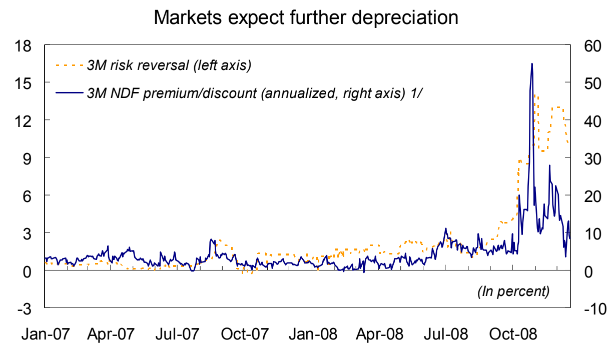
[10] Banks have to compete for funds with small savings schemes, whose administered interest rates are not linked to market rates and act as a floor for commercial bank deposit rates. Linking these rates to market rates, as proposed by the Reddy and Mohan committees in the early 2000s, would facilitate monetary policy transmission.

[11] As discussed in Chapter III of the accompanying Selected Issues Paper, the exchange rate pass through is likely to be relatively weak in an economic downturn and in an environment of volatile exchange rates.

[12] In this connection, staff noted that the government should fund its entire borrowing requirement through regular government securities, rather than issuing special-purpose bonds.

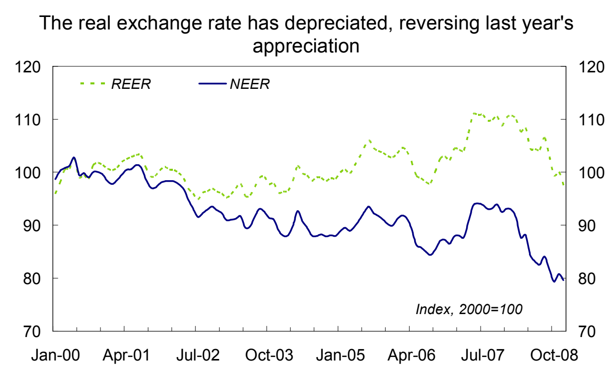
could (i) introduce a longer-term (say 1 month) repo facility available to all counterparties, and (ii) increase the amounts available under the 90-day special refinance facility and announce its extension until at least end-2009.[13] If these steps should still prove insufficient, the RBI could consider extending eligibility of collateral accepted at its repo window to corporate bonds and commercial paper, but with adequate safeguards regarding a minimum credit rating and appropriate discount. The latter measure would also boost the liquidity of corporate bonds, aiding market development and the monetary policy transmission mechanism. Measures along these lines have been taken by numerous countries (Box 3).

24. **Exchange rate policy needs to be consistent with ensuring sufficient liquidity in the system.** Until November, the large foreign exchange intervention undertaken in the wake of large capital outflows exacerbated pressures on domestic liquidity and resulted in a large loss in reserves. If pressures on the rupee were to re-emerge, letting the exchange rate find a floor would create the conditions under which exchange rate expectations provide incentives for capital inflows. The downside risks of such an approach for banks and corporates would likely be limited, as banks' foreign exchange exposure is subject to strict limits and corporates' exposure to exchange rate risk appears low.[14] Collecting data on and disclosing the overall unhedged foreign exchange exposure of the corporate sector would help reduce uncertainty about its financial health.



Source: Bloomberg L.P.

1/ Positive implies expectation of a rupee depreciation.



Source: IMF, Asia and Pacific Department database.

25. **The rupee appears broadly in line with its equilibrium level.** In 2008, the rupee depreciated over 14 percent in nominal effective terms and 11 percent in real effective terms, and is broadly in line with its long-term average. The latest IMF Consultative Group on Exchange

[13] By increasing the availability of term money, these steps would be of more general benefit to the development of India's financial markets.

[14] As discussed in Chapter I of the Selected Issues Paper, foreign exchange debt is estimated at 20–30 percent of corporate debt and stress tests indicate that corporate balance sheets are more sensitive to interest rate risk than exchange rate risk.

Box 3: Select Cross-Country Comparisons of Financial Measures

This box provides a selective list of financial market measures taken by other emerging market countries in the past few months.

Domestic Liquidity Provision

- Hong Kong SAR: Longer-term liquidity (collateralized lending raised from 1 to 3 months).
- Korea: Expanded collateral for repos (bank bonds, guaranteed mortgage-backed securities, MBS).
- Philippines: Expanded collateral for domestic repos (to include FX sovereign debt).
- Russia: Expanded collateral for repos (stocks, government guaranteed MBS); expansion of counterparties to repo operations (low-rated banks); provision of long-term liquidity (up to 1 year, no collateral).
- Japan: Expanded collateral for repos (additional government bonds; guaranteed asset-backed commercial paper; lower quality corporate debt).

FX Liquidity Provision

- Brazil: $20 bn central bank credit line for corporates with FX debt and $10 bn for exporters; auctions of 1-month USD liquidity lines; allow BRZ sovereign debt as collateral for FX repos.
- Hong Kong SAR: the HKMA to conduct FX swaps with banks on an as-needed basis.
- Hungary: overnight FX swap facility for domestic banks, facilitated by an agreement between the Central Bank and the ECB.
- Korea: $5 billion Ex-Im Bank credit line (banks); $55 billion BOK credit line for trade finance.
- Turkey: daily dollar auctions to inject FX; limit on export rediscount loans raised.

Facilities to Supplement International Reserves

- Korea, Brazil, Mexico, Singapore: FX swaps with US Fed.
- Korea: FX swaps with Japan ($20bn) and China ($28 bn).
- Hungary: FX swap with the ECB (€5 bn).
- Iceland: FX swaps with Nordic central banks (€1.5 bn).

Credit Guarantees

- Hong Kong SAR: loan guarantee fund for non-listed companies with risk sharing up provisions.
- Korea: Expansion of government credit guarantee program for SMEs.
- Russia: Government to provide corporate loan guarantees to improve liquidity conditions.
- Japan: Expanded guarantees on new SME lending up to 6 percent of GDP.
- UK: Government guarantee for half of up to $30 bn of new and existing SME bank loans with risk sharing provisions.

Bank Recapitalization

- Brazil: Two largest state banks allowed to purchase stakes in private banks.
- Hong Kong SAR: Contingent Bank Capital Facility (HKMA).
- Korea: Bank Capital Expansion Fund ($15.5 billion), financed by the Bank of Korea, the Korea Development Bank, and outside investors.
- Russia: Long-term subordinated debt financing ($30 bn), primarily to state-owned banks, from central bank and government.

Rate (CGER) exercise also continued to show that the rupee is close to its equilibrium level, although considerable uncertainty surrounds the impact of the crisis on the current account and capital flows. Even though there were large sales of FX during the recent market turmoil, there was sizable two-way intervention during 2008.

26. **A limited amount of foreign exchange could be made available in the form of swaps to relieve foreign exchange shortages and allay concerns about external financing.** The RBI's recent introduction of foreign exchange swaps for banks with foreign branches or subsidiaries is welcome. If broader foreign exchange shortages should materialize, the RBI could hold regular foreign exchange auctions, open to all RBI counterparties and with the total amount available (over a specified period of time) announced at the outset. Brazil, for example, has introduced such FX swap facilities and direct FX loans to corporates, announcing a sizable amount up front. The amount committed would need to be meaningfully large, within the constraints posed by reserve adequacy. India's reserves remain comfortable compared to imports, short-term external debt, and the external gross financing requirement, and cover more than 70 percent of non-FDI external liabilities. However, they represent only about 30 percent of domestic financial liabilities (M3), which might become the more relevant metric if financial stability conditions were to deteriorate markedly.[15]

Authorities' Views and Plans

27. **The RBI stated that the steps they had already taken to boost liquidity had proven effective, as evidenced by the decline in the interbank rate to within the policy rate corridor.** In addition, the introduction of new refinance facilities for certain sectors of the economy (e.g., exporters, housing finance companies, and small and medium-sized enterprises) were helping to alleviate stress on these sectors and obviating the need to expand repoable collateral. The authorities noted that several of the RBI's new and expanded liquidity facilities (including those for foreign exchange) had not been fully utilized, and that banks were depositing excess liquidity in the RBI's overnight facility and still had unused collateral with which to access the RBI's repo facility, especially after the build-up in their government securities' holdings in recent weeks. These factors indicated that liquidity pressures had been addressed successfully.

28. **The authorities saw little evidence of unmet credit demand, but expressed concerns about slowing credit growth which they viewed as primarily demand-driven.**

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[15] Obstfeld, Shambaugh, and Taylor ("Financial Stability, the Trilemma, and International Reserves," NBER Working Paper No. 14217, 2008) notes that concerns about domestic financial stability were a key motive for emerging markets' massive reserve accumulation in recent years.

RBI officials noted that banks continued to lend vigorously and that credit growth net of the additional demand for credit resulting from reduced external financing remained around 20 percent (y/y) until end-October. While they acknowledged that with deposit growth slowing it would be difficult for banks to reduce deposit rates and hence lending rates markedly, the RBI expected the cost of credit to moderate as the measures to improve the flow of credit took effect. However, they expressed concern about the slow pace of transmission from policy to market interest rates and about what appeared to be a noticeable decline in credit demand since October.

29. **The RBI indicated its willingness to consider adopting additional policy measures if needed, and they have since reduced interest rates and the CRR.** The RBI intended to continue coordinating its repurchase of market stabilization bonds closely with the issuance of government securities to minimize the net liquidity impact. Additional options if needed included lowering the CRR, lowering the SLR but with due consideration for its prudential importance, and possibly, increasing the amount of refinance available to financial institutions. Since India's banks remain financially robust, the RBI intended to keep relying on them as the primary channels of credit intermediation, including to nonbank financial institutions. Broadening the types of collateral accepted at the RBI's repo window might also be an option, though the RBI noted that in the case of corporate bonds, the absence of a robust secondary market (and hence of reliable pricing information) would make it difficult to accept them. Finally, the authorities highlighted the importance of an exit strategy from the exceptional policy measures adopted in the wake of the crisis, and noted that many of these measures included explicit sunset provisions.

30. **The RBI reaffirmed that India pursues a flexible exchange rate policy, intervening only to smooth volatility.** In this connection, they pointed to the large depreciation of the rupee against the U.S. dollar in recent months. However, the authorities were skeptical about the staff's recommendation of letting the exchange rate find a floor, since in times of financial volatility, the floor has no significance.

B. Keeping Credit Flowing While Maintaining Financial Stability: The Role of Financial Sector Policy

Context

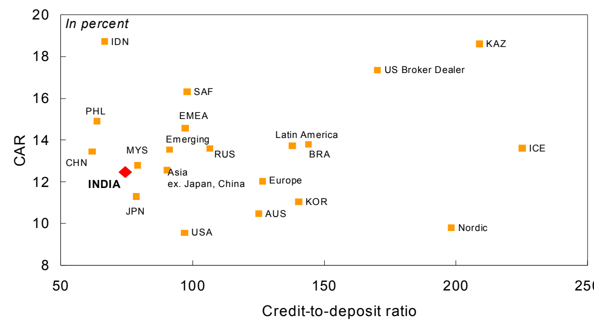
31. **Based on headline indicators India's financial system compares favorably internationally, but rising credit risk and liquidity pressures are putting it under strain (Box 4).** Indian banks appear well-capitalized, relatively liquid, and have low NPA ratios and only limited exposure to structured credit products and troubled financial institutions. However, over the last few years, a rapid domestic credit expansion, combined with a sharp increase in foreign liabilities, has increased banks' vulnerability to slowing economic activity and global deleveraging. The downturn in the corporate sector (including in real estate) is of

Box 4. India: Financial Stability Risks

Financial stability risks in India have risen in line with global developments. CDS spreads for Indian banks jumped sharply in mid-September and although they have eased since November, the remain elevated and are comparable to those of Indonesian and Korean banks, which are perceived to be vulnerable countries. The Moody's KMV one-year expected default frequencies (EDFs) have also spiked, but are lower than default probabilities implied by CDS spreads. The credit ratings of major Indian banks have also been affirmed with only ICICI's U.K. subsidiary being revised downward to the same level as the parent company and three other small banks downgraded since the global financial crisis began. Some market analysts note that current CDS spreads overstate the risk of default of Indian banks, and reflect instead the severe dislocation and illiquidity of Indian CDS.

Indian banks compare favorably internationally in terms of capitalization and wholesale funding risks. Their average capital adequacy ratio (CAR) is 12½ percent, with tier 1 capital close to 9 percent.[1] Their credit-to-deposits (CD) ratio at 74 percent is relatively low, particularly compared to those countries bearing the brunt of the global crisis.[1] The CD ratio of Indian banks is affected by a 24 percent SLR held mostly in cash and government securities, which provides a cushion against liquidity shocks.

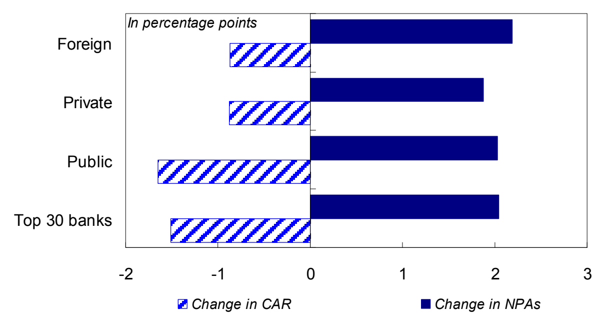
CAR and liquidity appear adequate



Source: UBS.

India's banking system, however, remains vulnerable, especially to credit and liquidity risks.

Banks' capital should be able to withstand a doubling of NPAs



Sources: Bankscope; and Fund staff estimates.
1/ Based on staff's stress test estimates of top thirty banks by asset size as of March 2008.

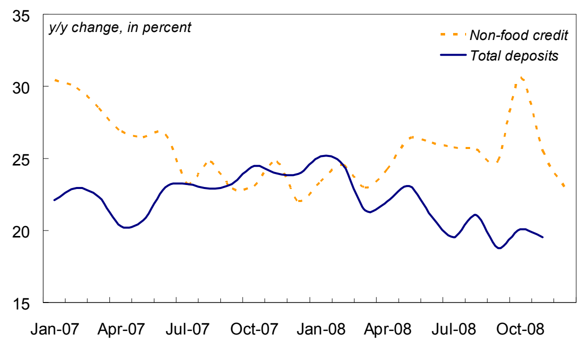
Credit risk. Staff's stress tests indicate that the capitalization of systemically important banks does not drop below the regulatory CAR minimum (9 percent) if impaired loans rise to twice the current gross NPA ratio of 2½ percent. This provides some comfort. However, spillovers from the global financial crisis coinciding with the turning of the domestic credit cycle could result in a substantial increase in NPAs. For example, some countries during the Asian crisis saw NPAs increase as much as 200-300 percent. In such an extreme scenario, the capital position of a number of Indian systemically important banks would fall below the minimum CAR. In addition, while banks' interest rate risk is relatively low as most loans (including mortgages) are at floating rates, indirect credit risks related to an interest rate spike could be significant. In terms of sectoral exposure, industry accounts for about 40 percent of total bank credit (of which roughly a quarter is to small firms). The property sector, which has come under considerable stress with real estate prices already down sharply and likely to fall further, accounts for about 19 percent of bank credit (with the majority accounted for by housing loans), although this does not include the indirect exposure via nonbank financing institutions and collateral.

[1] These data refer to September 2008.

Box 4. India: Financial Stability Risks, Concluded

- **Liquidity risk.** Even before the onset of the recent crisis, Indian banks had seen much more rapid credit than deposit growth. This had been accompanied by a sharp rise in external liabilities to BIS reporting banks (with liabilities at US$51billion at end-June 2008 or about 5 percent of total assets, double their end-2006 level) financing a growing share of foreign currency loans to residents (from 16.2 percent of total foreign assets in March 2001 to 47.8 percent in December 2007), suggesting a potential maturity mismatch in their FX book. The largest share of external liabilities is accounted for by nonresident deposits (27 percent), a relatively stable source of finance, although in the past they have declined at times of stress. Starting in September, the withdrawal of foreign credit lines to banks in India and Indian bank branches abroad increased dollar funding risks. While banks responded by borrowing in the domestic interbank market, the spike in interest rates demonstrated the link between domestic and global liquidity.

Credit growth has outpaced deposit mobilization



Sources: CEIC Data Company Ltd; and Fund staff calculations.

- **Exposure to structured credit products, troubled financial institutions, and derivatives.** According to the RBI, India has virtually no exposure to U.S. subprime mortgage assets or to other structured credit products. The total exposure to five troubled global institutions is reported at US$1 billion (0.1 percent of system's assets). While these exposures are small compared to earnings and capital, they are fairly concentrated. As in Korea, Indian banks also face an earnings shock from FX derivatives losses (the authorities estimate mark-to-market losses at $5.5 billion).

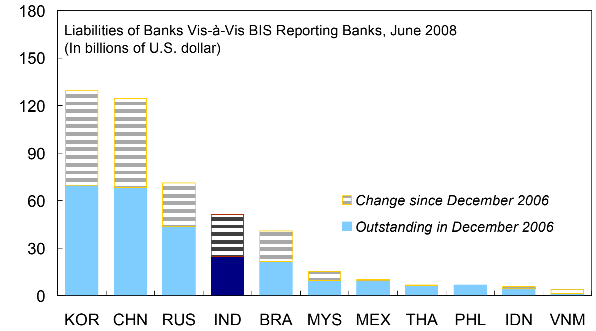
- **Foreign exchange risk.** Stringent daily limits on net foreign exchange open position limits and restrictions on foreign borrowing by banks are deemed to have limited their exposure to FX risks. Nevertheless, it is not clear to what extent banks may be affected indirectly by corporations' unhedged FX exposures and/or FX derivative losses. Also, within their FX book, banks may have maturity mismatches, which have not been publicly disclosed.

- **Equity risk:** banks' overall exposure to equity is limited to less than 40 percent of net worth and if loans are secured against shares, the margin has to be 50 percent: nevertheless, the latter may be insufficient in some cases when equity volatility is as high as in recent months.

- **There are also several information gaps (e.g. off-balance sheet derivative positions, and foreign borrowing mismatches and covenants) that make a conclusive assessment of financial stability risks difficult.** These gaps call for further data dissemination, analysis of asset quality, and stress testing of banks allowing for extreme events, multiple factors and feedback loops from the corporate sector.

particular concern, as is the fact that risks appear to be concentrated in a few institutions. Information gaps, especially related to derivatives positions and data for detailed stress tests, cloud the staff's assessment. In addition, significant duration mismatches and deteriorating asset quality in NBFCs are worrisome. These problems have in turn affected MFs, which are some of the main investors in the securities issued by NBFCs. While MFs and NBFCs have combined assets equivalent to only 14 percent of banking assets, they are linked to banks through funding relationships and the combined impact of their stress on the cost of working capital as witnessed by the spike in commercial paper rates make them systemically important.

Indian banks had recently increased funding from foreign sources



Source: Bank for International Settlements, Consolidated Banking Statistics, October 2008.

32. **In light of the deterioration in economic conditions, the RBI has eased prudential guidelines for loans.** Provisioning norms for lending to sectors that had previously been subject to higher standards (such as real estate, personal loans, and exposures to capital markets) have been reduced to the rate prevailing for most other loans. Similarly, risk weights on exposures previously subject to a higher risk weight have also been reduced. Commercial real estate loans have been made eligible for special treatment under the RBI's prudential regulations for restructured loans, such that even after restructuring loans can continue to be classified as "standard". In addition, standard accounts (except exposures to commercial real estate, capital markets, and personal loans) that have to undergo a second restructuring no longer need to have their loan classification downgraded.

Policy Response

33. **These circumstances call for careful identification and disclosure of systemic risks in the financial system.** Detailed analysis of bank asset quality and off-balance sheet structures is essential, with mark-to-market accounting important to ensure that asset quality problems are not masked.[16] Multifactor stress tests for extreme events, particularly credit and liquidity shocks and allowing for feedback loops between the financial and nonfinancial sectors, which have tended to be greatly underestimated in a number of countries, would be

[16] The insurance regulator's decision to direct life insurers to furnish data on the performance of their funds is a step in the right direction.

advisable.[17] Stepped-up efforts of this type have been adopted by the Hong Kong Monetary Authority, which has intensified stress testing of banks and brokers and issued additional guidance to them. Data on critical variables such as open foreign exchange exposures and derivative positions of financial institutions and corporates should be disseminated and monitoring mechanisms for foreign and other wholesale borrowing could be strengthened. (For example, Mexico recently required corporations to report the losses that would result from their derivative exposures for given changes in market variables.) The information gathered could then be disseminated through a regular financial stability report.

34. **International experience suggests that early loss recognition and bank recapitalization (where necessary) are the measures most likely to be effective in restoring the flow of credit.** Key steps in this process would include the following:

- **Avoiding masking the underlying capital position of financial institutions.** Recent reductions in provisioning requirements are consistent with countercyclical prudential regulation and cuts in risk weights can also be viewed in this light, particularly since they still meet the minimum Basel standards. However, measures that permit regulatory forbearance on asset classification—for example, allowing restructured assets not to be classified as NPAs—obscure banks' true asset quality and undermine confidence in the accuracy of their accounts in the absence of disclosure. These measures could defer the recognition of bad assets, encourage adverse selection of borrowers, and undermine risk management practices.

- **Providing incentives for early loss recognition.** Banks could be given the right to absorb the losses arising from the difference between the book and new net present value of restructured assets in a special account limited in size (say up to 1 percent of risk-weighted assets), not immediately set off against regulatory capital. The accounting losses in this account could be amortized over time or through capital raised when markets become vibrant again. Also, consideration could be given to making public money available to banks for recapitalization conditional on certain restructuring targets.

- **Identifying capital needs and recapitalizing banks.** The RBI should move quickly to estimate the likely increase in NPAs, and hence the possible need for additional capital. The authorities have announced their intention to raise the capital of some public banks to 12 percent of risk weighted assets, and have pledged spending of 0.4 percent of GDP for this purpose. This proposed increase in capital should be

[17] The BIS notes that the current crisis was possibly compounded by weaknesses in stress testing practices. See Bank for International Settlements, "Principles for sound stress testing practices and supervision" (January 2009), http://www.bis.org/publ/bcbs147.htm.

adequate to face an increase in NPAs of up to 200 percent, which is in line with India's past experience in the 2002–03 downturn, but may not be sufficient to withstand a more severe deterioration in asset quality. [18] If additional recapitalization were needed, private money should be the first option, given the limited fiscal space. With public banks accounting for about 70 percent of system assets, removing the 10 percent cap on single investors' voting rights and reducing the 51 percent minimum state ownership in public banks would be instrumental. If public recapitalization becomes necessary, high standards of transparency should be upheld, and a clear exit strategy announced. Given constraints on funding for recapitalization, it may be necessary to exercise regulatory forbearance on the minimum capital asset ratio (CAR) during the transition period of recapitalization.

- **Facilitating the disposal of impaired assets.** To bolster the market for NPAs, restrictions on foreign investment in asset reconstruction companies (ARCs) should be eased. Also to expand the participants in the NPA market, nonbank financial secured creditors should be given the same rights as bank secured creditors under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act.

35. **Cyclical and structural limitations on the banking system underscore the importance of advancing the authorities' financial reform agenda.** Besides cyclical factors, such as moderating deposit growth and high credit to deposit ratios, expansion of bank credit is also constrained by structural factors, including the high government borrowing requirement and priority sector lending. This highlights the importance of implementing recommendations to develop nonbank financing in line with the Rajan Report and accelerate capital account liberalization, as in the Tarapore II Report. Advances in these areas are essential to ensure that sufficient financing is available to support India's ambitious growth trajectory.[19] The priorities are as follows:

- **Developing the corporate bond market.** To build the institutional investor base, insurance companies and pension funds should be allowed to invest a greater share of their assets in corporate bonds. The enactment of the insurance and pension reform bills now in parliament would also be important. Foreign participation remains

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[18] International evidence suggests that bank recapitalizations during times of financial distress have cost on average 6 percent of GDP (Laeven and Valencia, 2008, "Systemic Banking Crises: A New Database" IMF Working Paper No. 08/224). The capital of the whole Indian banking system stood at about 7 percent of GDP as of March 2008. However, it should be noted that the latter is not the upper limit of potential recapitalization costs, which depend on the amount of impaired assets.

[19] Without this, financing India's ambitious target of $500 billion in infrastructure investment by 2012 would require more than doubling bank credit to infrastructure over the next four years.

instrumental to promote market liquidity, which will require raising the limits on FII investment in corporate bonds considerably.[20]

- **Further capital account liberalization.** The authorities have already taken numerous measures, some since the conclusion of the mission (see Box 1).[21] To sustain access of Indian borrowers to foreign capital and ensure smooth refinancing of external debt, all interest rate caps and minimum maturity requirements on foreign borrowing, including trade credits, should be lifted. To position India well for when the tide of capital flows turns, the authorities should (i) liberalize FDI, especially in the financial sector; (ii) ease restrictions on foreign borrowing and foreign participation in local debt securities markets;[22] and (iii) expand the range of contracts and participants in the derivatives markets. Consideration could be given to tapping multilateral development banks' trade credits. Rediscount facilities for trade credits could be expanded and foreign exchange auctions for this specific purpose (as part of the foreign exchange swaps proposed above or separately as outright sales) could be carried out.

- **Improving banking system efficiency and reach.** When credit is less readily available, the premium on its efficient allocation becomes greater. Efficiency could be improved by (i) lowering the minimum government ownership in public banks and increasing managerial autonomy; (ii) liberalizing interest rates on priority-sector loans and introducing priority-sector loan certificates; (iii) allowing greater foreign investment in banks; and (iv) allowing more consolidation in the banking sector, including by domestically incorporated subsidiaries of foreign banks.

36. **Government-assisted refinance and credit guarantees could also be an option to encourage banks to extend credit, but transparency and appropriate assessment and pricing of risks should be ensured.** In case unconventional measures entailing greater government intervention become necessary, government refinance and credit guarantees can be a timely and largely market-based means of alleviating a credit crunch. The advantage of these programs is that they involve sharing of risk and reward, while loans would be administered by the banks, thus exploiting their technical expertise. There are a number of

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[20] The limit on FII investment in corporate bonds was raised to $15 billion from $6 billion on January 2, 2009.

[21] Portfolio equity investment is highly liberalized and restrictions on ECBs have been gradually eased. Nevertheless, ECBs are still subject to a number of restrictions, and FDI to sector-specific limits and exclusions.

[22] For example, market participants indicated that there is good appetite for mezzanine financing—a hybrid product of equity and debt financing, which is considered external commercial borrowing—and investing in distressed assets, but current restrictions are binding.

these programs in India, for example, via the EXIM Bank, the National Housing Bank, and the Small Industries Development Bank of India, where the RBI provides refinancing, and more recently via the India Infrastructure Finance Company Limited (IIFCL), which will issue government-guaranteed bonds to provide refinancing for infrastructure. The government could allow the IIFCL to ratchet-up its refinancing activities and expand the scope of its support for public-private partnerships (PPPs) by permitting further debt issuance. However, due regard would need to be paid to transparency by disclosing the contingent liabilities and managing the resulting fiscal risks. Recently, Hong Kong SAR and the U.K. introduced credit guarantees for nonlisted companies and SMEs, respectively, with explicit risk sharing mechanisms. Consideration would also need to be given to lifting interest rate ceilings on on-lending to reflect the true credit risks of borrowers or to providing explicit partial guarantees for excess risk held by financial institutions.

37. **Crisis preparedness exercises would enhance the authorities' ability to intervene quickly if financial conditions were to deteriorate significantly.** These exercises should aim especially at strengthening cross-institutional coordination, speeding up decision making processes, and reviewing intervention frameworks. An interagency task force may be helpful in this regard. For example, Hong Kong SAR has established a Task Force on Economic Challenges and Korea has set up a high level committee to prepare contingency plans. Also, should concerns about financial stability intensify, possibly as a result of financial contagion, the authorities could consider arranging foreign exchange swaps with other central banks and availing themselves of the IMF's Short-Term Liquidity Facility (SLF) to allay concerns about the availability of external financing.[23] If the funding situation of banks deteriorated substantially, a guarantee on banks' new debt could be considered such as in Korea, given that capital controls limit the scope for residents' outflows. An explicit blanket guarantee to all banks' creditors should be reserved for more extreme events.

Authorities' Views

38. **The RBI reiterated that the financial system is well capitalized and that the policy stance has consistently balanced growth, inflation, and financial stability concerns.** They noted that the RBI's Financial Self Assessment, which will be published in early 2009, confirmed this assessment. With the average regulatory CAR at about 13 percent, well above the 9 percent minimum (which in turn is 1 percentage point above the minimum under Basel II), the authorities did not expect that a major bank recapitalization program would be needed although a few smaller public banks may require additional capital. In the medium term, banks generally were deemed to have sufficient headroom to maintain a 12 percent CAR, despite the increase in bank assets and the new requirements under

[23] India would have access of up to SDR20.8 billion under the SLF.

Basel II.[24] Derivatives exposures were largely concentrated in foreign banks operating in India, while daily net foreign exchange open positions limits were strictly enforced. Detailed analysis of institutions' assets and off-balance sheet items was already underway through periodic off-site and on-site inspections.[25] With regards to the sharp deterioration of banks' market performance (e.g., equity prices and CDS spreads), the RBI noted that these were poor indicators of credit risk perception of financial institutions, and that in any case such market information was only available for a few banks.

39. **The authorities did not yet see any evidence of a turn in the credit cycle and maintained that banks were well-positioned to weather a deterioration in market conditions.** Instead of banks' reluctance to lend, the problem was more that high economic growth witnessed in the last few years had resulted in a sharp rise in demand for bank credit and the onset of the global financial turmoil had further raised this demand due to the drying up of external funding sources. Moreover, India's banks have sufficient margins (loan to value ratio) and capital to absorb loan losses should they materialize, although at present there was no reason to expect a substantial increase in NPAs. Indeed, RBI officials stated that the stress tests carried out in the RBI's self assessment—which is yet to be published—had not revealed significant risks in this respect.

40. **The RBI emphasized that appropriate regulatory and supervisory measures had already been undertaken to maintain financial stability and keep credit flowing.** RBI officials noted that systematic stress testing was being done and that reporting of banks' exposure to sensitive sectors (such as real estate, unsecured consumer lending, SMEs, and equities) and their liquidity positions had recently been enhanced: a new liquidity monitoring framework had just been established for rupee funds and a similar one was being developed for FX liquidity. Recent reductions in provisioning requirements and risk weights to particular sectors were counter-cyclical prudential measures. Moreover, allowing restructured assets not to be classified as NPAs was seen as a temporary measure to encourage banks to restructure their assets during the current slowdown as it is always better to go for restructuring rather than allow the impaired assets to turn into NPAs. They noted that coordination among agencies was already effective and that the Prime Minister himself headed a committee tasked with sustaining growth and safeguarding financial stability. Finally, the deposit insurance coverage was judged to be adequate covering 93 percent of the total number of accounts as against international benchmarks of 80 percent.

[24] Apart from equity, banks have been provided with a variety of capital raising options for Tier I and II capital, such as innovative perpetual debt instruments, upper Tier -II debt, preference shares, and subordinated debt.

[25] In India, off-balance sheet vehicles in the form of SPVs for securitization exist, but extensive guidelines, in line with the international best practices, have been issued and liquidity facilities to SPVs are subject to a capital charge.

41. **The authorities were satisfied with the functioning of India's insolvency framework.** The corporate debt restructuring framework (for out-of-court workouts) and the SARFAESI Act (which strengthens the hand of secured creditors) have worked well, facilitating debt restructuring and improving recovery rates by creditors. In addition, during 2008, the RBI has granted certificates of registration to five new ARCs, bringing the total to eleven.

42. **The authorities noted that financial sector reforms were proceeding as planned.** Banking system efficiency had improved since the beginning of the financial sector reforms in the 1990s and the government would review the role of public and foreign ownership of banks as planned in mid-2009. Listing procedures for corporate bonds had been streamlined, and a state-of-the-art trading platform and settlement system would be implemented soon, guaranteeing delivery versus payment. However, the RBI was of the view that corporates have little interest in issuing bonds, preferring instead private placements. They acknowledged the importance of a healthy domestic institutional investor base, but noted that in the current environment, investors preferred the safety of government securities. Easing prudential restrictions on the corporate bond holdings of pension funds and insurance companies was therefore unlikely to be effective.

43. **The authorities argued that capital account liberalization has been in line with the country's long-term strategy as outlined in the Tarapore II Report.** As for accelerating liberalization, the RBI noted that with prospects for capital inflows quite low, liberalization at this time would not have any notable impact on raising external financing. Moreover, the RBI maintained that easing restrictions on foreign investment in corporate bonds would expose India to risks associated with volatile capital flows while offering excess returns to foreign investors. Finally, the authorities considered that interest rate caps on foreign borrowing were advisable from a prudential point of view to prevent exposing domestic borrowers to extremely high rates of interest which could result in systemic stress.[26]

C. India's Corporate Sector: A Challenging Outlook

Background

44. **While corporate balance sheets appeared healthy through early 2008, the recent sharp deterioration in financial and economic conditions is likely to have heightened vulnerabilities.** Staff's analysis suggested that such a deterioration is likely to have more than doubled the share of companies facing difficulties in servicing their debt (defined as

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[26] Nevertheless, on January 2, 2009, the authorities abolished the interest rate cap on ECBs on a temporary basis.

firms with earnings below interest expenses).[27] Moreover, the exceptional equity volatility and the steep fall in equity prices have increased the probability of distress.

Policy Response

45. **Problems in the corporate sector may give rise to demands for support, but direct government intervention in specific companies or sectors is fraught with risks.** From an efficiency standpoint, the financial sector, with much greater ability to assess firms' earnings potential, is in a significantly better position to allocate scarce financial resources. Direct government support for specific sectors and companies is also likely to pose governance challenges. Similarly, while pressures for increased trade protection will intensify, trade restrictions would be highly counterproductive.[28] Hence, public financial support would be best concentrated on providing financial institutions with the resources they need to keep credit flowing.

46. **Ensuring that the insolvency framework is ready to handle a potentially large rise in corporate distress is a high priority.** As companies run down their liquidity cushions, India may face a significant rise in corporate distress. In this regard, staff noted that implementation of Rajan Report recommendations to improve the bankruptcy law and enhance out-of-court restructuring mechanisms, as well as passage of the Companies Bill, would represent major steps forward. They also encouraged the authorities to consider strengthening incentives for operational restructuring (and reducing incentives for pure rescheduling of debt) under India's Corporate Debt Restructuring framework. As mentioned above, better functioning of ARCs and enhanced incentives to renegotiate debts for financial institutions would also facilitate a speedier resolution and higher recovery rates.

Authorities' Views

47. **The authorities expressed a more sanguine outlook for the corporate sector.** While India's firms may experience rising difficulties, they expected them to be contained at the level of a normal business cycle, as their performance had been very strong in recent years and hence firms were well-positioned to weather the downturn. With regards to restructuring mechanisms, they emphasized that India's existing framework for resolving corporate distress was already working well. Finally, the authorities reiterated that they did not plan to introduce trade restrictions.

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[27] See Chapter I of the Selected Issues Paper for details.

[28] Since the onset of the crisis, India has increased import duties on selected steel products and reduced exemptions from countervailing duties on cement and from custom duties on zinc and alloys, reversing measures that had been taken earlier in 2008. Export taxes have also been cut.

D. Fiscal Policy: Limited Room for Further Stimulus

Background

48. **After five years of fiscal consolidation, India's public finances deteriorated markedly in 2008/09.** Between 2003, when the Financial Responsibility and Budget Management Act (FRBMA) was passed, and 2007/08, strong revenue performance driven by rapid growth and enhanced tax administration lowered the deficit and public debt (see Figure 4). The 2008/09 Budget envisaged continued consolidation targeting a 2.5 percent of GDP central government deficit compared to 2.8 percent in 2007/08. But with elections approaching, and the sharp rise in international oil prices in an unreformed subsidy regime, the government's ability to maintain fiscal discipline was severely tested. A soaring subsidy bill and a number of schemes that were not fully provisioned in the budget (e.g. the agricultural debt write-off, the NREG, and the wage hike) led to a substantial widening of the deficit. The 2008/09 central government budget deficit is now projected to reach 7 percent of GDP, including subsidy-related bonds. The states' deficit is projected to widen to about 2¾ percent of GDP, resulting in a general government deficit of almost 10 percent of GDP. Weaker corporate profits, lower imports, and a deeper downturn in economic activity, which have started to weigh on both direct and indirect tax collections, are the main downside risks. On the upside, lower commodity prices could lighten the subsidy bill.

Near-Term Policy Response

49. **High government debt and deficits limit room for further fiscal stimulus.** Staff's estimate of the discretionary fiscal measures provided in the budget and the two supplementary budgets is sizable, amounting to about 3 percent of GDP.[29] In addition, the IIFCL was allowed to issue bonds fully backed by a sovereign guarantee and the ceiling for states' market borrowing was raised. With a high deficit and debt close to 80 percent of GDP, among the highest in emerging markets, expanding the deficit further could turn out to be contractionary, through its impact on India's

Major Discretionaly Fiscal Measures in 2008/09 will contribute to a substantial widening of the deficit

	(In percent of GDP)
Budget (and Supplementary Budgets) 2008/09	
Tax measures 1/	1.1
Spending 2/	1.8
Fiscal Stimulus Packages (Dec 2008, Jan 2009) 3/	
Tax measures	0.2
Spending	0.4
Total	3.5
Other (off-budgetary) measures 3/	1.7
Within 2008/09	0.7
Beyond 2008/09	0.9

1/ Includes post-budget, inflation-related cuts in customs duties.

2/ Reflects full amount of agricultural debt relief (Rs 600bn). The related net cash outgo in 2008/09 is Rs 150bn.

3/ For details, see Box 1.

[29] This excludes the impact of tax cuts implemented earlier in the year to contain inflation.

risk premium, interest rates, and credit rating.[30] In this context, the limited fiscal space would best be reserved for measures to jumpstart high quality infrastructure investment and strengthen the financial system.

50. **If the authorities deem further fiscal stimulus necessary to support demand, it should be accompanied by reforms that ensure medium-term fiscal sustainability.** Setting out a medium-term debt target and announcing credible accompanying reforms will boost confidence in the government's commitment to fiscal discipline when market conditions stabilize. If implemented, the fiscal stimulus should be timely and take into account implementation constraints to avoid governance lapses. Additional spending could focus on accelerating already planned infrastructure projects or increasing the public component of PPPs. Expanding well-targeted social programs that would raise the purchasing power of the poor, who have a high propensity to consume, could also be a valid alternative. Tax cuts, however, would likely be ineffective. The personal income tax base is very narrow, while for corporates, the impact would be small given the anticipated decline in profits; moreover, tax changes may be difficult to reverse.

51. **Although getting back to the FRBMA targets is not feasible, next year's budget should strive to achieve a reduction in the central government deficit.** Lower oil prices are estimated to reduce the 2009/10 subsidy bill by 2 percentage points of GDP, but revenue growth could decline as automatic stabilizers are triggered by slower economic activity. Thus, it would be inadvisable to offset fully the savings on the subsidy bill with additional discretionary spending measures. Moreover, the fiscal position of the states will likely deteriorate as growth in own revenues and resources transferred from the center decelerates, while spending pressures from the implementation of the Sixth Pay Commission public sector pay award persist. Next year's budget should also bring all spending on-budget to improve transparency and outline a concrete strategy for returning to a sustainable fiscal position in the Medium-Term Fiscal Policy Statement.

52. **Lower commodity prices offer an opportunity to reform the subsidy system, which would provide a powerful signal of the government's commitment to expenditure reform, and thus fiscal discipline**. The 2008/09 subsidy bill at 3⅔ percent of GDP (roughly equal to general government education and health outlays) highlights the centrality of subsidies in rationalizing spending. As suggested by the recent Chaturvedi Committee Report, a subsidy reform should eliminate regressive subsidies, namely on petroleum and diesel, phase out the LPG subsidy, and introduce a market-based pricing mechanism that aligns domestic prices to international levels. Carrying out this reform at a time of weak

[30] See Giavazzi and others (2000) "Searching for Nonlinear Effects of Fiscal Policy: Evidence from Industrial and Developing Countries," *European Economic Review* 44, pp. 1259–1289 and Scott and others (2008) "Fiscal Policy as a Countercyclical Tool" in IMF*, World Economic Outlook,* October 2008.

commodity prices would minimize the impact on domestic demand and inflation. Improved targeting for subsidies on kerosene, food and fertilizers and strengthening the delivery mechanism would enhance subsidies' efficiency and lower costs with minimal disruptions to the poor. In this regard, this year's pilot introduction of smart cards, as well as the plans to allot unique identification numbers to India's residents, are welcome steps.

Medium-Term Reform Agenda

53. **Beyond the current downturn, fiscal consolidation continues to be a key priority as public finances remain India's Achilles heel.** As emerging market investors are expected to be far more discriminating in the coming period, addressing this key vulnerability will be important to attract inflows, boost confidence, and buttress the credibility of measures that might be needed to strengthen the financial system. Also, fiscal consolidation remains necessary to gain room for countercyclical measures and expenditures related to the financial sector if needed. As credit markets thaw, consolidation will also be necessary to reduce the risks of crowding out.

54. **The medium-term fiscal adjustment should be anchored in a fiscal rules framework centered on a debt target.** With the current fiscal responsibility law setting targets through 2009/10, a new fiscal rule that addresses the weaknesses in the current FRBMA framework and is buttressed by comprehensive expenditure reforms, could play an important role in promoting fiscal consolidation.[31] An eventual successor to the FRBMA could entail a significant expansion of the coverage of the fiscal operations of the public sector and include an explicit medium-term debt target, combined with consistent annual nominal expenditure growth rules. These rules would squarely put the focus of fiscal policy on debt sustainability, tackle the deficit bias at its very core (expenditure overruns), and allow for a more countercyclical fiscal policy by letting the automatic stabilizers operate. Subsidy reform should be complemented by ongoing efforts to improve spending efficiency, such as output-based budgeting and improved service delivery. The introduction of a goods and service tax will be an important milestone for strengthening the revenue collection efforts and streamlining indirect taxes.

Authorities' Views and Plans

55. **The authorities reiterated their commitment to the process of fiscal consolidation as a prerequisite for sustained growth: however, they underscored that this is not the time for fiscal rectitude**. They acknowledged that the overall central government fiscal and current deficit for 2008/09 will exceed the budget estimates due to the rise in commodity

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[31] Chapter IV of the accompanying Selected Issues Paper discusses India's experience with fiscal rules and proposes possible changes.

prices in the first half of the year as well as the fiscal measures taken in December and January to support growth. However, the authorities disagreed with staff's projected 2008/09 fiscal outturn for the states, arguing that states' revenue has remained buoyant and that the usual lag in the introduction of the pay increases at the state level would limit expenditure pressures. For the remainder of the year, the government will focus on pruning unproductive expenditure and monitoring the FRBMA targets closely. The authorities do not envisage the need for further measures in the current fiscal year.

56. **They argued that the fiscal consolidation of the last five years, and the concomitant reduction in public debt, have created room for the current fiscal expansion**. Also, the increase in government borrowing was being largely offset by the repurchase of market stabilization bonds, such that the impact of government spending on overall liquidity and credit available to the private sector has been minimized. The authorities were in agreement with staff's suggestions on the form that any further fiscal stimulus should take, namely an acceleration of spending on infrastructure projects that have already been launched, higher spending on easily scalable targeted social programs (such as NREG, housing for the poor, social assistance programs) and a limited role for tax measures. They also agreed that implementation capacity constraints had to be taken into account.

57. **The authorities concurred that a return to the FRBMA targets was unrealistic for next year's budget**. The slowdown in economic growth will likely necessitate continued fiscal stimulus. In addition, a significant ramp up in priority spending is in the works. The plan spending for next year will also include funds for the recapitalization of public sector banks. However, details on the broad outline of the 2009/10 Budget and the expected fiscal stance were not available as a full budget, which would reflect the policy agenda of the newly elected government, will be prepared only after the government is formed, likely as late as July.

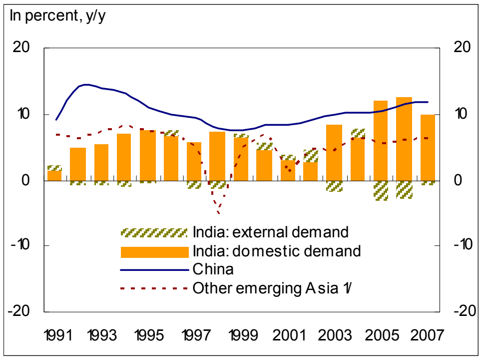
58. **The authorities agreed that reforms are necessary to secure lasting consolidation and signal the government's commitment to fiscal discipline.** The government remains committed to reducing the subsidy bill and is exploring reform options, as evidenced by the introduction of a pilot smart card scheme. While there are signs that the fuel subsidy reform might be gaining support, the timing of such a politically difficult reform is unclear. Regarding plan spending, the authorities emphasized their increased focus on judicious spending of funds and expenditure management, as well as the limited scope for further rationalization of centrally sponsored schemes. On the revenue front, they argued that there are still substantial gains to be achieved on both direct and indirect taxes through ongoing compliance improvements and base-broadening.

59. **The authorities viewed the FRBMA as having been very useful in instilling fiscal discipline.** They pointed to its role in sensitizing ministries and departments and acting as a catalyst for fiscal consolidation at the state level. However, as the Thirteenth Finance

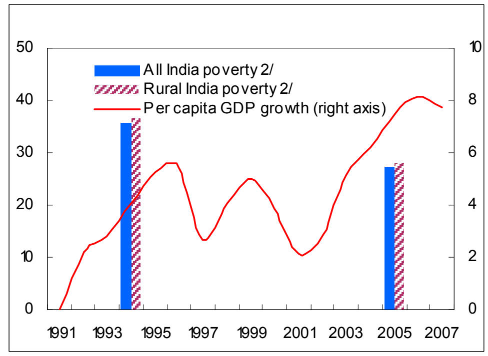
Commission, tasked with assessing the need for a successor to the FRBMA, has not yet issued its recommendations, the authorities were noncommittal on the staff's proposal for a potential successor rule which includes an explicit debt target and nominal expenditure growth rules.

Figure 1. India: A Long-Term Perspective

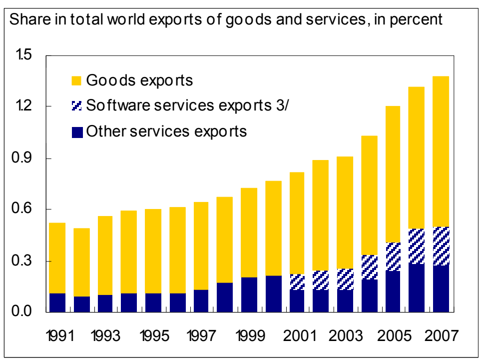
India is one of the fastest growing economies, with growth driven mostly by domestic demand.



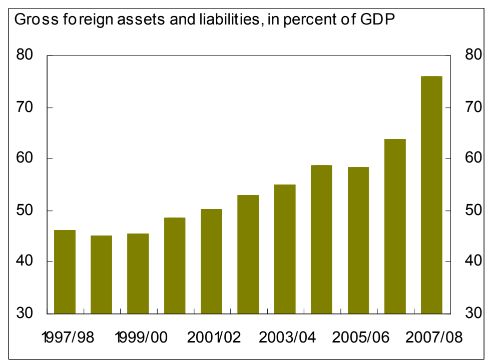
The fast economic expansion has led to a substantial reduction in poverty.



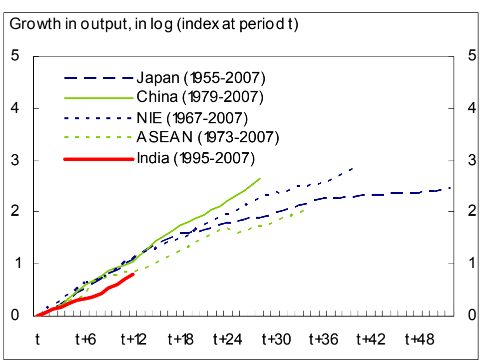
India has emerged as an important global player, capturing a rising share of world exports...



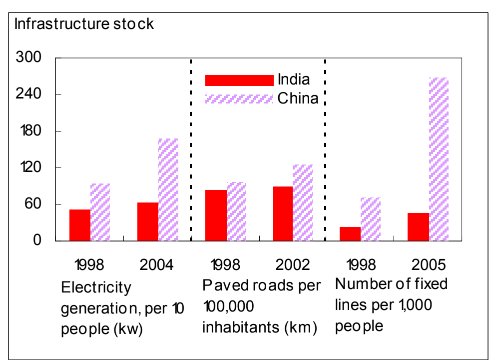
...and becoming increasingly financially open.



India is likely in the beginning phase of a long-run growth takeoff...



...provided investment to remove structural constraints to growth remains strong.



Sources: CEIC Data Company Ltd.; World Development Indicators; and Fund, *World Economic Outlook* and staff calculations.

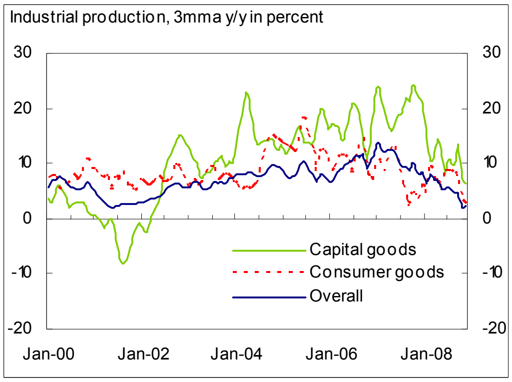
1/ Simple average of GDP growth in Hong Kong SAR, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China and Thailand.

2/ Defined as percentage of people below the poverty line.

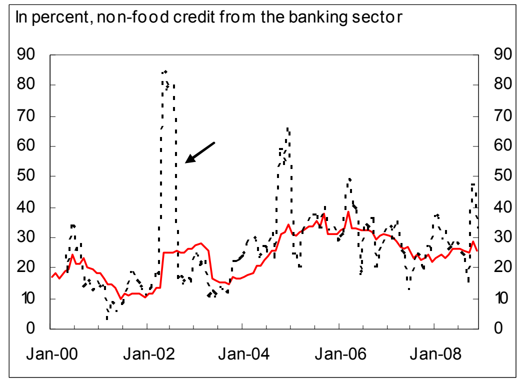
3/ Data for the full year available from 2001. Prior to 2000 India's software exports were not significant.

Figure 2. India: Conjunctural Developments

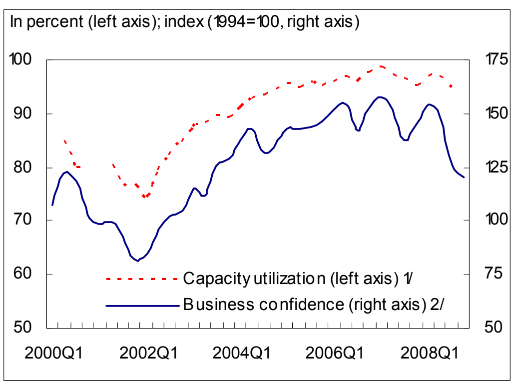
Despite fiscal stimulus supporting consumption, growth is slowing driven by investment.



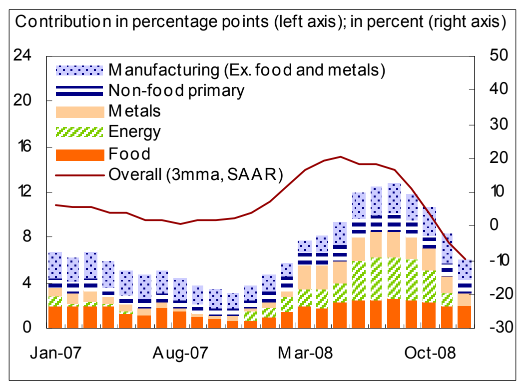
With credit growth decelerating and having to substitute for other funding sources…



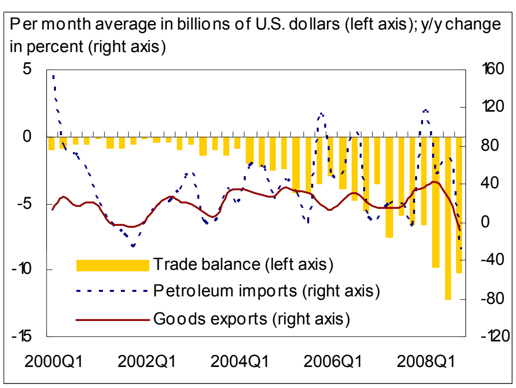
…activity is likely to weaken, as shown by forward looking indicators



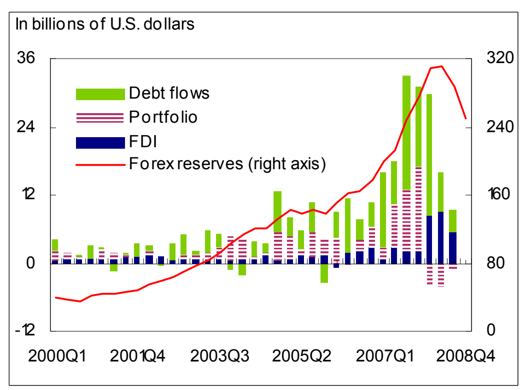
Inflation has fallen sharply from its 16-year high in mid-2008.



Exports contracted lately, but lower imports kept trade deficit in check…



…which, together with a sharp drop in capital inflows, has pushed the overall BoP into deficit.



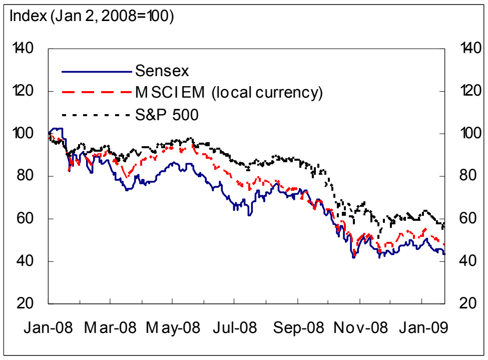
Sources: Reserve Bank of India; National Council of Applied Economic Research, India; CEIC Data Company Ltd.; Bloomberg L.P.; and Fund staff calculations.

1/ Percent of NCAER survey respondents operating at or close to capacity.

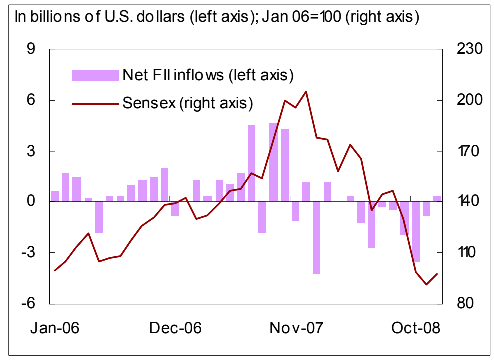
2/ NCAER index.

Figure 3. India: Impact of the Global Financial Crisis

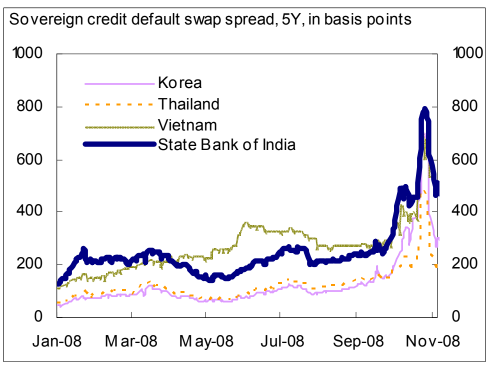
Taking the cue from global markets, equity markets in India have declined...



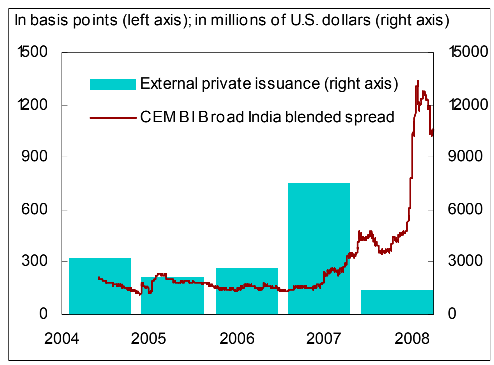
...driven by heavy portfoilo outflows.



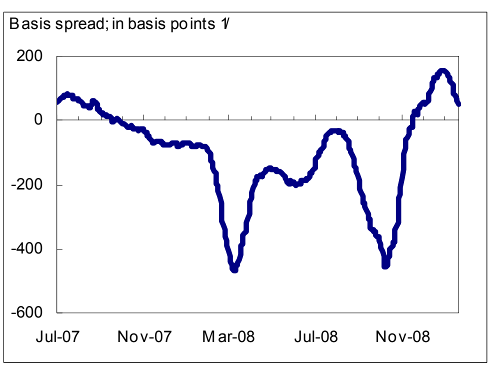
Credit conditions have tightened in line with rising global risk aversion...



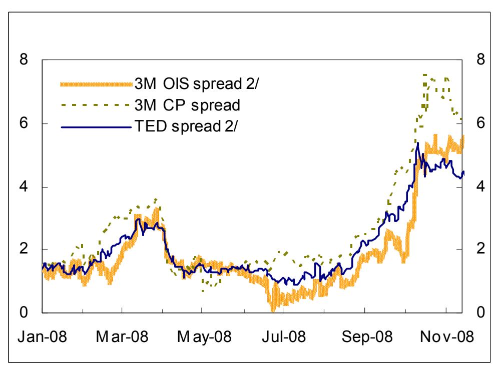
...resulting in lower appetite for Indian bonds.



Dollar funding has been under pressure...



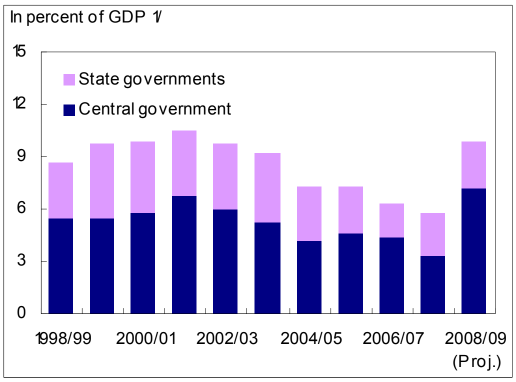
...and domestic liquidity conditions are tight.



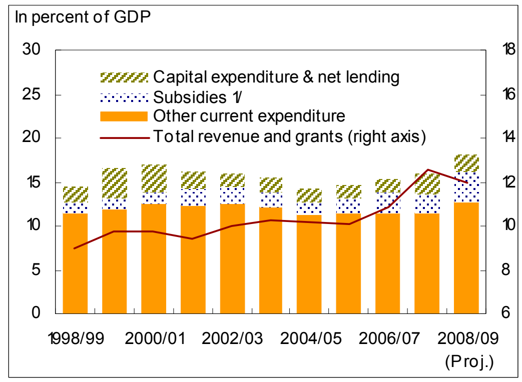
Sources: Reserve Bank of India; Bloomberg L.P.; Dealogic; and Fund staff calculations.
1/ Priced from 3-month currency forwards and computed from 20-day moving average.
2/ Difference from 3-month National Stock Exchange Mumbai Interbank Offer Rate (MIBOR).

Figure 4. India: Fiscal Indicators

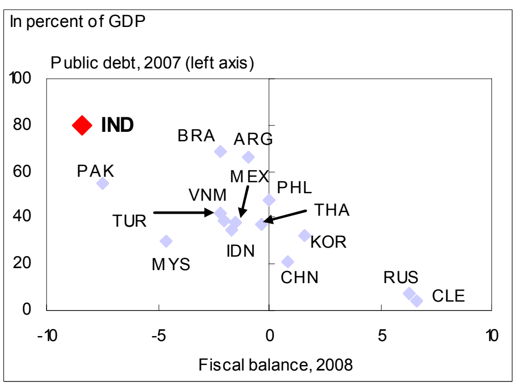
The trend of fiscal consolidation will be reversed in FY 2008/09...



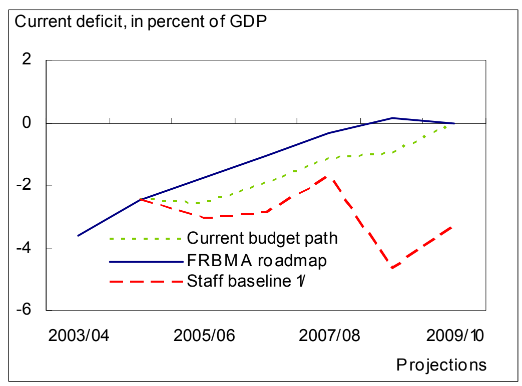
...as fiscal measures and a soaring subsidy bill weigh on government finances.



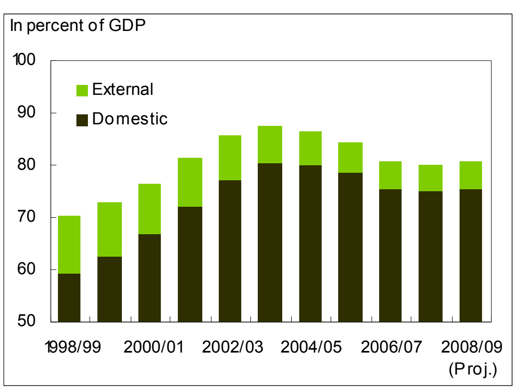
India's fiscal position is one of the weakest among the emerging economies.



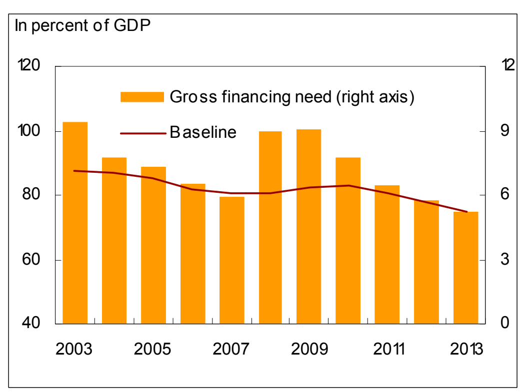
Achieving the FRBMA target of no current deficit in 2009/10 will likely be infeasible.



Public debt remains high.



Under the baseline scenario, debt reduction would resume only in 2010/11.



Sources: Country authorities; and Fund staff calculations.
1/ Includes subsidy-related bond issuance.

Table 1. India: Millennium Development Goals, 1990–2006 1/

	1990	1995	1998	2001	2004	2006
Eradicate extreme poverty and hunger 2/						
Income share held by lowest 20%	...	...	...	...	8.1	...
Malnutrition prevalence, weight for age (% of children under 5)	...	...	44.4	...	43.5	...
Poverty headcount ratio at national poverty line (% of population)	...	36.0	...	28.6	27.5	...
Prevalence of undernourishment (% of population)	...	25.0	21.0	...	20.0	...
Achieve universal primary education 3/						
Literacy rate, youth total (% of people ages 15-24)	61.9	...	...	76.4	...	...
Persistence to grade 5, total (% of cohort)	...	...	59.7	61.4	73.0	...
Primary completion rate, total (% of relevant age group)	63.8	77.1	69.7	72.4	83.8	85.7
School enrollment, primary (% net)	...	...	...	78.5	89.4	88.7
Promote gender equality 4/						
Proportion of seats held by women in national parliament (%)	5.0	...	7.0	9.0	9.0	8.3
Ratio of girls to boys in primary and secondary education (%)	70.3	...	82.1	79.8	90.3	91.4
Ratio of young literate females to males (% ages 15-24)	67.1	...	...	80.5	...	...
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	12.7	14.4	16.0	16.8	17.9	...
Reduce child mortality 5/						
Immunization, measles (% of children ages 12-23 months)	56.0	72.0	51.0	53.0	58.0	59.0
Mortality rate, infant (per 1,000 live births)	80.0	74.0	72.0	66.0	61.6	58.7
Mortality rate, under-5 (per 1,000)	114.9	101.5	...	89.3	...	78.4
Improved maternal health 6/						
Births attended by skilled health staff (% of total)	...	34.2	42.3	42.5	...	46.6
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	...	...	...	...
Combat HIV/AIDS, malaria, and other diseases 7/						
Children orphaned by HIV/AIDS	...	...	...	...	...	...
Contraceptive prevalence (% of women ages 15-49)	43.0	...	...	46.9	...	56.3
Incidence of tuberculosis (per 100,000 people)	167.8	...	...	...	...	...
Prevalence of HIV, female (% ages 15-24)	...	...	...	...	...	...
Prevalence of HIV, total (% of population ages 15-49)	...	...	...	...	...	0.3
Tuberculosis cases detected under DOTS (%)	...	0.3	1.6	23.1	55.3	63.8
Ensure environmental sustainability 8/						
CO2 emissions (metric tons per capita)	0.8	1.0	1.1	1.1	1.2	...
Forest area (% of land area)	21.5	...	...	22.7	...	22.8
GDP per unit of energy use (constant 2000 PPP $ per kg of oil equivalent)	3.2	3.4	3.7	3.9	4.3	4.5
Improved sanitation facilities (% of population with access)	14.0	...	...	23.0	...	28.0
Improved water source (% of population with access)	71.0	77.0	...	82.0	...	89.0
Nationally protected areas (% of total land area)	...	...	...	...	...	...
Develop a global partnership for development 9/						
Aid per capita (current US$)	1.6	1.9	1.6	1.6	0.6	1.2
Debt service (PPG and IMF only, % of exports of G&S, excl. workers' remittances)	...	...	...	...	...	...
Fixed line and mobile phone subscribers (per 1,000 people)	0.6	1.3	...	3.6	...	24.3
Internet users (per 1,000 people)	...	...	...	0.5	...	17.8
Total debt service (% of exports of goods, services and income)	31.9	29.7	21.2	14.7	13.8	7.7
Unemployment, youth female (% of female labor force ages 15-24)	...	8.0	...	10.2	10.8	...
Unemployment, youth male (% of male labor force ages 15-24)	...	8.4	...	10.1	10.4	...
Unemployment, youth total (% of total labor force ages 15-24)	...	8.3	...	10.1	10.5	...
General indicators						
Fertility rate, total (births per woman)	3.8	3.4	3.3	3.1	2.7	2.5
GNI per capita, Atlas method (current US$)	390.0	380.0	420.0	460.0	630.0	820.0
GNI, Atlas method (current US$) (billions)	330.9	350.2	415.1	478.6	680.6	914.7
Gross capital formation (% of GDP)	24.2	26.6	22.6	24.2	31.6	36.0
Life expectancy at birth, total (years)	59.1	61.4	62.2	62.9	63.4	64.5
Literacy rate, adult total (% of people ages 15 and above)	48.2	...	...	61.0	...	...
Population, total (millions)	849.5	932.2	982.2	1,032.5	1,079.7	1,109.8
Trade (% of GDP)	15.7	23.1	24.0	26.4	37.9	47.2

Source: *World Development Indicators* database, September 2008.

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 one 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 Social and Economic Indicators, 2004/05–2009/10 1/

I. Social Indicators

GDP (2007/08)		**Poverty (Percent of population)**	
Nominal GDP (billions of U.S. dollars):	1,173	Headcount ratio (2003/04):	27.5
GDP per capita (U.S. dollars):	999	Undernourished (2000):	21.0
Population characteristics (2007)		**Income distribution (2004, WDI)**	
Total (in billions):	1.2	Richest 10 percent of households:	31.1
Urban population (percent of total):	29.3	Poorest 20 percent of households:	8.1
Life expectancy at birth (years):	64.5	Gini index:	36.8

II. Economic Indicators

	2004/05	2005/06	2006/07	2007/08	2008/09 2/ Proj.	2009/10 2/ Proj.
Growth (y/y percent change)						
Real GDP (at factor cost)	7.5	9.4	9.6	9.0	6.3	5.3
Non-agricultural sector	9.5	10.3	11.0	10.0	7.1	5.9
Industrial production	8.4	8.2	11.5	8.5	...	...
Prices (y/y percent change, period average for annual data)						
Wholesale prices (1993/94 weights)	6.5	4.4	5.4	4.7	8.8	1.9
Consumer prices - industrial workers (2001 weights)	3.8	4.4	6.7	6.2	7.8	3.4
Saving and investment (percent of GDP)						
Gross saving 3/	31.8	34.3	34.8	36.0	34.6	34.9
Gross investment 3/	32.2	35.5	35.9	37.5	37.6	36.4
Fiscal position (percent of GDP) 4/ 5/						
Central government deficit	-4.1	-4.7	-4.4	-3.4	-7.1	-5.7
General government deficit	-7.3	-7.3	-6.3	-5.8	-9.9	-8.8
General government debt	86.5	84.2	80.6	80.1	80.7	82.9
Money and credit (y/y percent change, end-period)						
Broad money	12.3	21.2	21.5	20.8	…	…
Credit to commercial sector	26.0	32.2	25.8	20.6	…	…
Financial indicators (percent, end-period)						
91-day treasury bill yield	5.3	6.1	8.0	7.2	…	…
10-year government bond yield	6.7	7.5	8.0	7.9	…	…
Stock market (y/y percent change, end-period)	16.1	73.7	15.9	19.7	…	…
External trade 6/						
Merchandise exports (US$ billions)	85.2	105.2	128.9	166.2	186.4	169.0
y/y percent change	28.5	23.4	22.6	28.9	12.2	-9.4
Merchandise imports (US$ billions)	118.9	157.1	190.7	257.8	298.0	265.5
y/y percent change	48.6	32.1	21.4	35.2	15.6	-10.9
Net oil imports (US$ billions)	22.9	32.3	38.3	52.2	60.0	38.6
Balance of payments (US$ billions)						
Current account balance	-2.5	-9.9	-9.6	-17.0	-35.1	-18.6
(in percent of GDP)	-0.4	-1.2	-1.0	-1.5	-3.0	-1.5
Foreign direct investment, net	3.7	3.0	7.7	15.4	19.9	14.0
Portfolio investment, net (equity and debt)	9.3	12.5	7.1	29.6	-11.7	-2.5
Overall balance	26.2	15.1	36.6	92.2	-27.9	-3.3
External indicators						
Gross reserves (in billions of U.S. dollars, end-period)	141.5	151.6	199.2	309.7	246.8	243.5
(In months of imports) 7/	8.9	7.7	7.7	10.5	9.1	8.0
External debt (in billions of U.S. dollars, end-period) 8/	133.0	138.1	171.4	224.8	229.0	238.0
External debt (percent of GDP, end-period) 8/	19.0	17.1	18.7	19.2	19.5	18.7
Of which : short-term debt 9/	4.6	3.3	3.8	7.3	7.6	7.9
Ratio of gross reserves to short-term debt (end-period) 9/	4.4	5.6	5.7	3.6	2.8	2.4
Gross reserves to broad money (percent; end-period)	27.5	24.8	26.1	31.0	28.9	...
Debt service ratio 10/	6.0	10.1	4.9	5.3	5.5	5.7
Real effective exchange rate 11/						
(y/y percent change, period average for annual data)	2.2	4.4	-2.2	8.2	…	…
Exchange rate (rupee/US$, end-period)	43.7	44.6	43.5	40.1	…	…
Memorandum items (in percent of GDP):						
Subsidy-related bond issuance 12/	0.0	0.5	1.0	0.6	1.3	0.3

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

1/ Data are for April-March fiscal years.
2/ Current staff projections.
3/ Differs from official data, calculated with gross investment and current account. Gross investment includes errors and omissions.
4/ Divestment proceeds treated as below-the-line financing.
5/ Subsidy-related bond issuance included in total expenditure.
6/ Annual data are on balance of payments basis.
7/ Imports of goods and services projected over the following twelve months.
8/ For projection, data are reported relative to staff's estimated annual GDP.
9/ Including short-term debt on contracted maturity basis, NRI deposits due within one year, and medium and long-term debt on residual maturity basis.
10/ In percent of current account receipts excluding grants.
11/ IMF INS calculation.
12/ Issued by the central government to FCI, the state-owned oil refining/distribution companies, and fertilizer companies as compensation for losses incurred from the provision of subsidies.

Table 3. India: Balance of Payments, 2004/05–2009/10 1/

(In billions of U.S. dollars)

	2004/05	2005/06	2006/07	2007/08	2008/09 Proj.	2009/10 Proj.
Current account balance	-2.5	-9.9	-9.6	-17.0	-35.1	-18.6
Merchandise trade balance	-33.7	-51.9	-61.8	-91.6	-111.6	-96.5
Merchandise exports	85.2	105.2	128.9	166.2	186.4	169.0
Merchandise imports	118.9	157.1	190.7	257.8	298.0	265.5
Oil	29.9	44.0	56.9	77.0	90.7	59.9
Non-oil	89.0	113.1	133.7	180.8	207.3	205.6
Non-factor services balance	15.4	23.2	29.5	37.6	40.3	41.5
Receipts	43.2	57.7	73.8	90.1	96.8	100.6
Of which: software services	17.2	23.6	31.3	40.3	...	...
Payments	27.8	34.5	44.3	52.5	56.5	59.1
Income, net	-5.0	-5.9	-7.3	-4.9	-10.1	-13.3
Transfers, net	20.8	24.7	30.1	41.9	46.3	49.6
Capital account balance	28.0	25.5	45.2	108.0	6.9	15.3
Direct investment, net	3.7	3.0	7.7	15.4	19.9	14.0
Of which: direct investment in India	6.0	8.9	22.7	34.2	25.8	19.1
Portfolio investment, net	9.3	12.5	7.1	29.6	-11.7	-2.5
Government borrowing, net	1.9	1.7	1.8	2.1	2.4	2.0
Commercial borrowing, net	5.2	2.5	16.1	22.6	0.8	-3.2
Short-term credit, net	3.8	3.7	6.6	17.2	-3.0	1.3
NRI deposits, net	-1.0	2.8	4.3	0.2	3.5	3.8
Rupee debt	-0.4	-0.6	-0.2	-0.1	-0.1	-0.1
Other capital, net 2/	5.5	-0.2	1.8	21.0	-5.0	0.0
Errors and omissions	0.6	-0.5	1.0	1.2	0.3	0.0
Overall balance	26.2	15.1	36.6	92.2	-27.9	-3.3
Valuation changes 3/	2.4	-4.9	11.0	18.4	-35.0	26.7
Increase in gross reserve stock (-, including valuation changes)	-28.6	-10.1	-47.6	-110.5	62.9	-23.4
Memorandum items:						
Foreign exchange reserves	141.5	151.6	199.2	309.7	246.8	295.1
In months of next year's imports (goods and services)	8.9	7.7	7.7	10.5	9.1	8.0
Current account balance (percent of GDP)	-0.4	-1.2	-1.0	-1.5	-3.0	-2.1
Merchandise trade balance (percent of GDP)	-4.8	-6.4	-6.7	-7.8	-9.5	-8.6
Overall balance (percent of GDP)	3.7	1.9	4.0	7.9	-2.4	-0.3

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

1/ Data are for April-March fiscal years. Indian authorities' presentation.

2/ Net other capital is sum of net banking capital (RBI format) 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, 2004/05–2008/09 1/

	2004/05	2005/06	2006/07	2007/08	2008/09		
					Jun.	Sep.	Dec.
Reserve money			(In billions of rupees, end-period)				
Reserve money	4,891	5,731	7,090	9,284	9,316	9,569	8,863
Net domestic assets of RBI	-1,237	-999	-1,572	-3,077	-4,084	-3,935	-3,078
Claims on government (net)	-180	66	24	-1,132	-1,132	-619	-316
Center	-233	52	21	-1,146	-1,132	-618	-319
States	53	14	3	14	0	0	3
Claims on commercial sector	14	14	15	18	14	19	14
Claims on banks	53	58	76	46	16	61	116
Other items (net)	-1,123	-1,152	-1,721	-2,009	-2,982	-3,397	-2,892
Net foreign assets of RBI	6,128	6,730	8,662	12,361	13,401	13,504	11,941
			(Contribution to reserve money growth)				
Reserve money	12.1	17.2	23.7	30.9	29.3	22.5	9.7
Net domestic assets of RBI	-17.4	4.9	-10.0	-21.2	-36.9	-24.6	-4.7
Claims on government (net)	-14.4	5.0	-0.7	-16.8	-13.0	1.6	13.4
Net foreign assets of RBI	29.4	12.3	33.7	52.2	66.1	47.0	14.4
Monetary survey			(In billions of rupees, end-period)				
Broad money (M3)	22,514	27,295	33,161	40,067	40,944	42,711	44,302
Currency with public	3,559	4,131	4,829	5,675	6,038	5,870	6,266
Deposits	18,891	23,096	28,257	34,302	34,857	36,787	37,911
Non-bank deposits at RBI	65	69	75	91	49	54	126
Net domestic assets	16,022	20,034	24,029	29,864	30,383	28,988	31,351
Domestic credit	20,370	24,596	29,676	34,770	35,497	37,348	39,684
Net credit to government	7,568	7,666	8,376	9,071	9,429	9,686	10,996
Of which: RBI	-180	81	58	-1,132	-1,132	-619	-316
Credit to commercial sector	12,802	16,930	21,301	25,699	26,069	27,662	28,687
Of which: commercial bank lending	11,004	15,071	19,312	23,619	24,140	25,510	26,445
Nonfood	10,593	14,664	18,847	23,175	23,634	25,059	25,924
Other items (net)	-4,348	-4,562	-5,647	-4,906	-5,114	-8,360	-8,332
Net foreign assets	6,493	7,262	9,132	10,203	10,561	13,723	12,951
			(Twelve-month percent change)				
Broad money (M3)	12.3	21.2	21.5	20.8	20.8	19.0	19.8
Net domestic assets	8.3	25.0	19.9	12.8	9.5	12.5	24.2
Domestic credit	15.8	20.7	20.7	17.2	19.8	19.6	25.2
Net credit to government	1.9	1.3	9.3	8.3	9.3	10.3	30.5
Credit to commercial sector	26.0	32.2	25.8	20.6	24.2	23.2	23.2
Of which: commercial bank lending	30.9	37.0	28.1	22.3	25.9	25.2	23.0
Nonfood	31.6	38.4	28.5	23.0	26.1	25.3	23.0
Net foreign assets	23.3	11.9	25.7	41.8	52.1	35.4	9.5
			(Contribution to broad money growth)				
Net domestic assets	6.1	17.8	14.6	9.3	7.0	9.0	16.9
Net credit to government	0.7	0.4	2.6	2.1	2.4	2.5	7.0
Of which: RBI	-3.1	1.2	-0.1	-3.6	-2.8	0.4	2.9
Credit to commercial sector	13.2	18.3	16.0	13.3	15.0	14.5	14.6
Net foreign assets	6.1	3.4	6.9	11.5	13.8	10.0	2.8

Sources: Reserve Bank of India; CEIC Data Company Ltd.; and Fund staff calculations.

1/ Data are for April - March fiscal years.

Table 5. India: Central Government Operations, 2004/05–2008/09 1/

	2004/05	2005/06	2006/07	2007/08		2008/09	
				Budget	Prov.	Budget	Staff proj.
	(In billions of rupees)						
Total revenue and grants	3,204	3,622	4,500	5,424	5,912	6,214	5,961
Net tax revenue	2,264	2,718	3,532	4,057	4,393	5,090	4,859
Gross tax revenue	3,050	3,662	4,735	5,481	5,911	6,877	6,566
Of which: corporate tax	827	1,013	1,443	1,684	1,895	2,264	2,265
income tax	493	560	751	988	1,057	1,383	1,276
excise taxes	991	1,112	1,176	1,302	1,233	1,379	1,190
customs duties	576	651	863	988	1,029	1,189	1,105
other taxes	163	326	502	520	697	662	730
Less: States' share	786	944	1,203	1,425	1,518	1,788	1,707
Nontax revenue 2/	915	874	943	1,346	1,492	1,106	1,085
Grants	26	30	25	21	27	18	18
Total expenditure and net lending	4,506	5,102	5,926	6,934	7,210	7,637	9,122
Current expenditure 3/	3,987	4,545	5,302	5,739	6,122	6,766	8,114
Of which: interest payments	1,269	1,326	1,503	1,590	1,715	1,908	1,912
wages and salaries	352	373	398	448	441	518	778
subsidies 4/	460	475	571	543	711	714	1,279
Capital expenditure and net lending 5/ 6/	519	557	624	1,195	1,089	871	1,008
Overall balance	-1,302	-1,480	-1,426	-1,509	-1,298	-1,423	-3,160
Overall balance (authorities' definition) 7/	-1,258	-1,464	-1,426	-1,509	-1,298	-1,333	-3,070
Overall balance (augmented) 8/	...	-1,653	-1,829	...	-1,586	...	-3,880
Financing	1,302	1,480	1,426	1,509	1,298	1,423	3,160
External (net)	148	75	85	91	93	110	110
Domestic (net)	1,155	1,405	1,341	1,418	1,205	1,313	3,051
	(In percent of GDP)						
Total revenue and grants	10.2	10.1	10.9	11.7	12.5	11.7	11.0
Net tax revenue	7.2	7.6	8.5	8.8	9.3	9.6	8.9
Gross tax revenue	9.7	10.2	11.4	11.8	12.5	13.0	12.1
Of which: corporate tax	2.6	2.8	3.5	3.6	4.0	4.3	4.2
income tax	1.6	1.6	1.8	2.1	2.2	2.6	2.3
excise taxes	3.1	3.1	2.8	2.8	2.6	2.6	2.2
customs duties	1.8	1.8	2.1	2.1	2.2	2.2	2.0
other taxes	0.5	0.9	1.2	1.1	1.5	1.2	1.3
Less: States' share	2.5	2.6	2.9	3.1	3.2	3.4	3.1
Nontax revenue 2/	2.9	2.4	2.3	2.9	3.2	2.1	2.0
Grants	0.1	0.1	0.1	0.0	0.1	0.0	0.0
Total expenditure and net lending	14.3	14.3	14.3	15.0	15.3	14.4	16.8
Current expenditure 3/	12.7	12.7	12.8	12.4	13.0	12.8	14.9
Of which: interest payments	4.0	3.7	3.6	3.4	3.6	3.6	3.5
wages and salaries	1.1	1.0	1.0	1.0	0.9	1.0	1.4
subsidies 4/	1.5	1.3	1.4	1.2	1.5	1.3	2.4
Capital expenditure and net lending 5/ 6/	1.6	1.6	1.5	2.6	2.3	1.6	1.9
Overall balance	-4.1	-4.1	-3.4	-3.3	-2.8	-2.7	-5.8
Overall balance (authorities' definition) 7/	-4.0	-4.1	-3.4	-3.3	-2.8	-2.5	-5.7
Overall balance (augmented) 8/	-4.1	-4.6	-4.4	...	-3.4	...	-7.1
Financing	4.1	4.1	3.4	3.3	2.8	2.7	5.8
External (net)	0.5	0.2	0.2	0.2	0.2	0.2	0.2
Domestic (net)	3.7	3.9	3.2	3.1	2.6	2.5	5.6
Of which: market borrowing	1.5	2.7	2.7	2.4	2.7	1.9	1.9
small savings (net of states' share)	0.1	0.2	0.1	0.3	-0.1	0.3	0.3
divestment receipts	0.1	0.0	0.0	0.0	0.1	0.2	0.2
Memorandum items:							
Primary balance	-0.1	-0.4	0.2	0.2	0.9	0.9	-2.3
Current balance 7/ 9/	-2.5	-2.6	-1.9	-0.7	-0.4	-1.0	-4.0
Current balance (augmented) 8/	...	-3.1	-2.9	…	-1.1	…	-5.3
Central government debt 10/	63.3	63.1	61.2	59.2	59.7	57.7	59.5
Subsidy-related bonds 11/	0.0	0.5	1.0	0.0	0.6	0.0	1.3
Of which: Food Corporation of India bonds	0.0	0.0	0.4	…	0.0	…	0.0
Oil bonds	0.0	0.5	0.6	…	0.5	…	1.0
Fertilizer bonds	0.0	0.0	0.0	…	0.2	…	0.4
Nominal GDP (in Rs. billion)	31,494	35,803	41,458	46,337	47,131	53,038	54,304

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

1/ Data for April - March fiscal year.

2/ In 2007/08, includes a special dividend payment from the RBI amounting to 0.7 percent of GDP. The authorities include this item under other capital receipts rather than non-tax revenue.

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

4/ Excludes subsidy-related bond issuance.

5/ Authorities' treatment of state debt swap scheme (DSS) in 2002-05 shows the prepayment by States of on-lent funds to the center as net lending. The Center's prepayment of its debt to the National Small Savings Fund (NSSF) is treated as a capital expenditure.

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

7/ Authorities' definition treats divestment as a revenue item until 2005/06 (included). In 2008/09, authorities treat proceeds from selling shares vested with SUTI (estimated at 0.2 percent of GDP) as revenue.

8/ Staff's definition treats divestment receipts as a below-the-line financing item. Includes subsidy-related bond issuance as current expenditure.

9/ In 2007/08, under the authorities' definition of the current deficit (which classifies the special dividend from the RBI as "other capital receipts"), the budget target for the current deficit is 1.5 percent of GDP. Staff includes this item under non-tax revenue.

10/ External debt measured at historical exchange rates.

11/ Issued by the central government to the Food Corporation of India, fertilizer producers, and the state-owned oil refining/distribution companies as compensation for losses incurred from the subsidized provision of commodities.

Table 6. India: General Government Operations, 2004/05–2008/09 1/

	2004/05	2005/06	2006/07 Prov 2/	2007/08 Budget	2007/08 Prov. 3/	2008/09 Budget	2008/09 Staff proj.
				(In billions of rupees)			
Total revenue and grants	6,127	7,040	8,735	10,265	10,878	11,920	11,552
Tax revenue 4/	4,941	5,785	7,261	8,422	8,845	10,245	9,899
Nontax revenue 5/ 6/	1,160	1,226	1,449	1,822	2,005	1,657	1,635
Grants	26	30	25	21	27	18	18
Total expenditure and net lending 7/ 8/	8,410	9,457	10,935	12,928	13,306	14,604	16,189
General government balance	-2,283	-2,417	-2,200	-2,663	-2,428	-2,684	-4,637
Financing	2,283	2,417	2,200	2,663	2,428	2,684	4,637
External (net)	148	75	85	91	93	110	110
Domestic (net)	2,136	2,342	2,116	2,572	2,335	2,574	4,528
Disinvestment receipts	44	16	24	118	126	252	252
				(In percent of GDP)			
Total revenue and grants	19.5	19.7	21.1	22.2	23.1	22.5	21.3
Tax revenue 4/	15.7	16.2	17.5	18.2	18.8	19.3	18.2
Nontax revenue 5/ 6/	3.7	3.4	3.5	3.9	4.3	3.1	3.0
Grants							
Total expenditure and net lending 7/ 8/	26.7	26.4	26.4	27.9	28.2	27.5	29.8
General government balance	-7.3	-6.7	-5.3	-5.7	-5.2	-5.1	-8.5
(including divestment receipts)	-7.1	-6.7	-5.2	-5.5	-4.9	-4.6	-8.1
(augmented with subsidy-related bonds)	…	-7.2	-6.3	…	-5.8	…	-9.9
Domestic financing (net)	6.8	6.5	5.1	5.6	5.0	4.9	8.3
Memorandum items:							
Primary balance	-1.2	-1.1	0.3	-0.4	0.4	0.4	-3.2
Nondefense capital expenditure	2.9	3.0	3.2	4.5	4.5	3.7	3.8
Net interest payments	6.1	5.7	5.6	5.4	5.6	5.4	5.3
Central government balance	-4.1	-4.1	-3.4	-3.3	-2.8	-2.7	-5.8
State and union territory governments' balance 9/	-3.5	-2.5	-1.9	-2.6	-2.5	-2.4	-2.7
Consolidation items 10/	0.4	-0.1	0.0	0.1	0.1	0.0	0.0
Subsidy-related bond issuance	…	0.5	1.0	…	0.6	…	1.3
General government debt	86.5	84.2	80.6	78.6	80.1	75.9	80.7

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/ Based on RBI's estimate of provisional outturn for state finances.
3/ Based on RBI's revised estimates of state finances.
4/ Tax revenue equals tax revenue of central government (CG), including NCCF and states' share, plus state tax revenue.
5/ Nontax revenue equals nontax revenue of CG, less interest payments by states on CG loans, plus nontax revenue of states.
6/ In 2007/08, includes a special dividend payment from the RBI amounting to roughly 0.7 percent of GDP. The authorities include this item under "other capital receipts".
7/ Expenditure and net lending equals total expenditure and net lending of CG (authorities' definition excluding subsidy-related bonds), less net loans and grants to states and union territories, plus total expenditure of states (excluding interest payments on CG loans).
8/ In 2007/08, includes 0.7 percent of GDP for the government's purchase of SBI shares from the RBI.
9/ The authorities treat states' divestment proceeds, including land sales, above-the-line as miscellaneous capital receipts. Staff's definition treats divestment receipts as a below-the-line financing item. Asset sales amount to 0.2 percent of GDP in 2007/08 and are budgeted at 0.3 percent of GDP in 2008/09.
10/ Above-the-line items in the CGA, which cancel out in the consolidation (e.g., loans to states).

Table 7. India: Macroeconomic Framework, 2004/05–2012/13 1/

					Projections				
	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Growth (percent change)									
Real GDP (at factor cost)	7.5	9.4	9.6	9.0	6.3	5.3	7.0	7.6	7.9
Non-agricultural sector	9.5	10.3	11.0	10.0	7.1	5.9	7.8	8.6	8.8
Real GDP (at factor cost, on calendar year basis)	7.2	9.1	9.8	9.3	7.3	5.1	6.5	7.5	7.8
Prices (percent change, period average)									
Wholesale prices (1993/94 weights)	6.5	4.4	5.4	4.7	8.8	1.9	4.0	3.9	3.9
Consumer prices	3.8	4.4	6.7	6.2	7.8	3.4	4.0	3.9	3.9
Interest rate on general government domestic debt (percent)	8.4	7.8	7.9	7.1	7.5	6.3	8.0	8.0	8.0
Saving and investment (percent of GDP)									
Gross saving 2/	31.8	34.3	34.8	36.0	34.6	34.9	34.5	34.7	35.2
Gross investment 3/	32.2	35.5	35.9	37.5	37.6	36.4	36.7	37.0	37.6
Fiscal position (percent of GDP)									
Central government balance - authorities 4/	-4.0	-4.1	-3.4	-2.8	-5.8	-5.4	-4.1	-3.3	-3.0
Central government balance - augmented 5/	-4.1	-4.7	-4.4	-3.4	-7.1	-5.7	-4.3	-3.5	-3.2
General government balance - augmented 5/	-7.3	-7.3	-6.3	-5.8	-9.9	-8.8	-7.3	-6.1	-5.6
General government debt	86.5	84.2	80.6	80.1	80.7	82.9	82.5	80.2	77.3
External trade (percent change, BOP basis)									
Merchandise exports (in U.S. dollar terms)	28.5	23.4	22.6	28.9	12.2	-9.4	10.2	12.5	12.7
Merchandise imports (in U.S. dollar terms)	48.6	32.1	21.4	35.2	15.6	-10.9	13.3	12.6	12.3
Balance of payments (in billions of U.S. dollars)									
Current account balance	-2.5	-9.9	-9.6	-17.0	-35.1	-18.6	-29.6	-35.3	-40.1
(in percent of GDP)	-0.4	-1.2	-1.1	-1.5	-3.0	-1.5	-2.1	-2.3	-2.4
(in percent of GDP, calendar year basis)	0.1	-1.3	-1.1	-1.0	-2.5	-1.8	-2.0	-2.3	-2.4
Foreign direct investment, net	3.7	3.0	8.4	15.4	19.9	14.0	20.7	19.6	19.9
Portfolio investment, net (equity and debt)	9.3	12.5	7.1	29.6	-11.7	-2.5	15.1	19.6	21.6
Overall balance	26.2	15.1	36.6	92.2	-27.9	-3.3	23.9	24.3	24.0
External indicators									
Gross reserves (in billions of U.S. dollars, end-period)	141.5	151.6	199.2	309.7	246.8	243.5	267.4	291.6	315.7
(in months of imports) 6/	8.9	7.7	7.7	10.5	9.1	8.0	7.8	7.3	7.0
External debt (in billions of U.S. dollars, end-period)	133.0	138.1	171.4	224.8	229.0	238.0	268.8	303.8	342.8
External debt (percent of GDP, end-period)	19.0	17.1	18.7	19.2	19.5	18.7	19.5	20.1	20.7
Of which : short-term debt 7/	4.6	3.3	3.8	7.3	7.6	7.9	8.8	9.3	9.7
Ratio of gross reserves to short-term debt (end-period) 7/	4.4	5.6	5.7	3.6	2.8	2.4	2.2	2.1	2.0
Debt service (percent of current account receipts)	6.0	10.1	4.9	5.3	5.5	5.7	7.0	8.5	8.4
Memorandum items (in percent of GDP):									
Subsidy-related bond issuance 8/	0.0	0.5	1.0	0.6	1.3	0.3	0.3	0.2	0.2

Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; and Fund 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 proceeds are treated as revenue until 2005/06 (included); excludes subsidy-related bond issuance.
5/ Divestment is treated as financing; includes subsidy-related bond issuance.
6/ Imports of goods and services projected over the following twelve months.
7/ Including short-term debt on contracted maturity basis, NRI deposits due within one year, and medium and long-term debt on residual maturity basis.
8/ Issued by the central government to FCI, the state-owned oil refining/distribution companies, and fertilizer companies as compensation for losses incurred from the provision of subsidies.

Table 8. India: Indicators of External Vulnerability, 2004/05–2008/09 1/

	2004/05	2005/06	2006/07	2007/08	2008/09 2/	
Financial indicators						
General government debt (percent of GDP)	86.5	84.2	80.6	80.1	80.7	(Projection)
Broad money (percent change, 12-month basis)	12.3	21.2	21.5	20.8	19.8	(December 2008)
Private sector credit (percent change, 12-month basis)	26.0	32.2	25.8	20.6	23.2	(December 2008)
91 day T-bill yield (percent; end-period)	5.3	6.1	8.0	7.2	4.8	(December 2008)
91 day T-bill yield (real, percent; end-period) 3/	-1.1	1.6	2.4	2.5	-1.0	(December 2008)
External indicators						
Exports (percent change, 12-month basis in US$) 4/ 5/	28.5	23.4	22.6	28.9	(9.9)	(November 2008)
Export volume (percent change, 12-month basis) 5/	11.7	15.5	16.5	15.3	14.9	(Projection)
Imports (percent change, 12-month basis in US$) 4/ 5/	48.6	32.1	21.4	35.2	6.1	(November 2008)
Import volume (percent change, 12-month basis) 5/	28.0	20.0	13.5	13.2	12.8	(Projection)
Terms of trade (percent change, 12 month basis) 5/	-3.5	-4.8	-2.3	-3.1	-0.1	(Projection)
Current account balance (percent of GDP)	-0.4	-1.2	-1.0	-1.5	-3.0	(Projection)
Capital and financial account balance (percent of GDP)	4.0	3.1	4.9	9.2	0.6	(Projection)
Of which : Net portfolio investment (debt and equity)	1.3	1.5	0.8	2.5	-1.0	(Projection)
Other investment (loans, trade credits, etc.)	1.4	1.3	3.1	3.6	0.3	(Projection)
Net foreign direct investment	0.5	0.4	0.8	1.3	1.7	(Projection)
Foreign currency reserves (billions of US$)	141.5	151.6	199.2	309.7	254.6	(December 2008)
RBI forward liabilities (billions of US$)	0.0	0.0	0.0	-14.7	-0.1	(October 2008)
Official reserves (in months of imports of goods and services)	8.9	7.7	7.7	10.5	9.1	(Projection)
Ratio of foreign currency reserves to broad money (percent)	27.5	24.8	26.1	31.0	28.0	(December 2008)
Total short-term external debt to reserves (percent) 6/	22.7	17.7	17.6	27.6	36.2	(Projection)
Total external debt (percent of GDP)	19.0	17.1	18.7	19.2	19.5	(Projection)
Of which: public sector debt	8.9	7.3	6.7	6.1	6.3	(Projection)
Total external debt to exports of goods and services (percent)	103.5	84.8	84.5	87.7	80.9	(Projection)
External interest payments to exports of goods and services (percent)	2.4	3.2	2.7	3.2	3.2	(Projection)
External amortization payments to exports of goods and services (percent)	4.8	8.8	3.1	3.3	3.4	(Projection)
Exchange rate (per US$, period average)	44.9	44.3	45.2	40.3	48.7	(December 2008)
REER (y/y change in percent; end-period)	1.4	4.2	0.1	5.2	-11.6	(December 2008)
Financial market indicators						
Stock market index (end-period)	6,493	11,280	13,072	15,644	9,647	(December 2008)
Foreign currency debt rating						
Moody's Investor Services	Baa3	Baa3	Baa3	Baa2	Baa2	(December 2008)
Standard and Poor's	BB+	BB+	BBB-	BBB-	BBB-	(December 2008)
Fitch Ratings	BB+	BB+	BBB-	BBB-	BBB-	(December 2008)

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

1/ Data for April-March fiscal year.
2/ Latest date available or staff estimate, as noted.
3/ Equals nominal yield minus actual WPI inflation.
4/ Data for 2008/09 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, NRI deposits due within one year, and medium and long-term debt on residual maturity basis.

Table 9. India: Indicators of Financial System Soundness, 2004/05–2008/09

	2004/05	2005/06	2006/07	2007/08	2008/09 Q1
Measures of financial strength and performance 1/					
Risk-weighted capital adequacy ratio (CAR)	12.8	12.3	12.3	13.0	12.7
Public sector banks	12.9	12.2	12.4	12.5	12.3
Old Private Sector Banks	12.5	11.7	12.1	14.1	13.9
New Private Sector Banks	12.1	12.6	12.0	14.4	14.1
Foreign banks	14.0	13.0	12.4	13.1	12.2
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) 2/ 3/	2.0	1.2	1.0	1.0	1.1
Public sector banks	2.1	1.3	1.1	1.0	1.0
Old Private Sector Banks	2.7	1.7	1.0	0.7	0.8
New Private Sector Banks	1.9	0.8	1.0	1.2	1.5
Foreign banks	0.9	0.8	1.0	1.2	0.7
Gross nonperforming loans (percent of outstanding loans) 3/	5.2	3.3	2.5	2.3	2.4
Public sector banks	5.5	3.6	2.7	2.2	2.2
Old Private Sector Banks	6.0	4.4	3.0	2.3	2.4
New Private Sector Banks	3.6	1.7	1.9	2.5	3.2
Foreign banks	2.9	2.0	1.8	1.8	1.9
Number of institutions with net NPLs above 10 percent of advances	4	3	1	0	…
Public sector banks	0	0	0	0	…
Old Private Sector Banks	0	0	0	0	…
New Private Sector Banks	0	0	0	0	…
Foreign banks	4	3	1	0	…
Net profit (+)/loss (-) of commercial banks 4/	0.9	0.9	0.9	1.0	0.9
Public sector banks	0.9	0.8	0.8	0.9	0.6
Old Private Sector Banks	0.3	0.6	0.7	1.0	0.8
New Private Sector Banks	1.1	1.0	0.9	1.0	0.6
Foreign banks	1.3	1.5	1.7	1.8	2.7
Balance sheet structure of all scheduled banks					
Loan/deposit ratio	65.5	72.0	74.5	71.5	73.9
Investment in government securities/deposit ratio	43.5	34.3	30.5	32.7	30.3
Lending to sensitive sectors (in percent of loans and advances)					
Real estate	12.7	17.2	18.8	18.0	…
Capital market	1.4	1.5	1.8	2.5	…
Commodities	0.2	0.3	0.0	0.1	…

Source: Reserve Bank of India: Report on Trend and Progress of Banking in India, 2007-08.

1/ Some loan classification and provisioning standards do not meet international standards.

2/ Gross nonperforming loans less provisions.

3/ Starting in 2001/02, figure includes ICICI, formerly a large development finance institution, which merged with ICICI Bank Ltd. in 2002.

4/ In percent of total assets.

INTERNATIONAL MONETARY FUND

INDIA

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the Asia and Pacific Department

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Contents Page

ANNEX I: INDIA—MEDIUM-TERM PUBLIC DEBT SUSTAINABILITY ANALYSIS

A. The Baseline Scenario

Staff assumptions. After a significant dip in 2009/10, economic growth is forecast to rise gradually to potential (8 percent) as global conditions improve and progress is made on structural reforms (see Table 6). Inflation is projected to remain contained. Despite continued fiscal stimulus, the general government deficit is expected to decline marginally in 2009/10 as lower commodity prices lighten the subsidy bill and the effect of the Sixth Pay Commission wage hike wears off. Other working assumptions include:

- *Oil bonds*. After 2008/09, the government is assumed to issue oil bonds to the state-owned petroleum companies only to cover the subsidy cost of kerosene.

- *Other off-budget bond issuance.* After 2008/09, the government is assumed not to issue further bonds to the Food Corporation of India or the fertilizer companies as these expenses are brought on-budget.

Debt path. Under the baseline scenario, the general government deficit would fall to 5.1 percent of GDP by 2013/14 from nearly 10 percent of GDP in 2008/09. Over the same period, gross public debt would decline to 74 percent of GDP from 80 percent of GDP in 2007/08, although it is projected to rise in 2008/09 and 2009/10 to a peak of 83 percent of GDP.

FRBMA targets. However, achievement of current balance by the central government, targeted for 2009/10 under the FRBMA, is not expected within the next 5 years, due to the expected ramp-up of plan spending to support growth in 2009/10, and the government's commitments on account of the agricultural debt write-off.

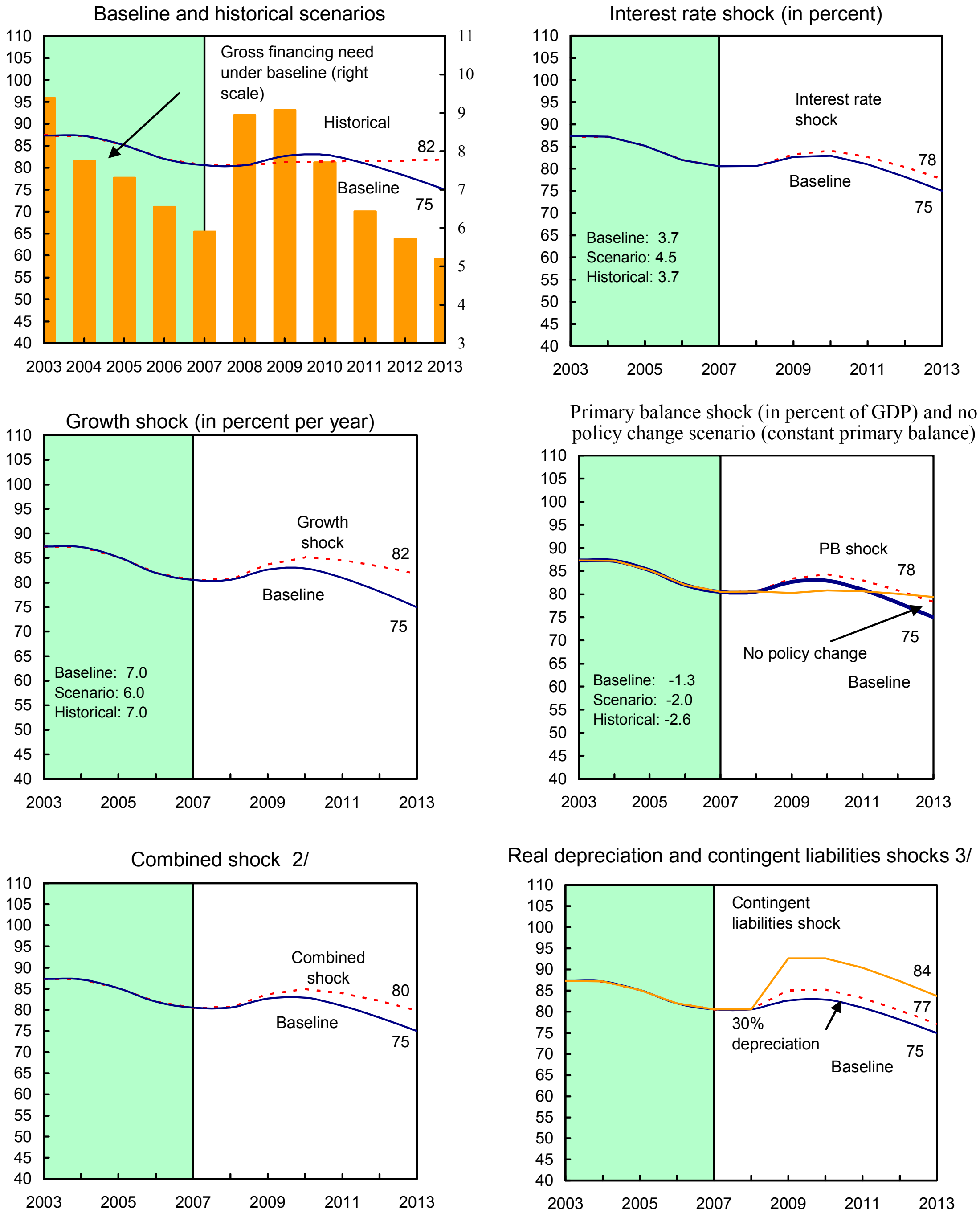
B. Sensitivity Analysis

After an initial rise, a gradual decline in the debt-to-GDP ratio would occur under various shocks, including in a scenario where the growth-interest rate differential rises above its historical average or the currency experiences a sharp depreciation (Figure I.1 and Table I.1).

However, in the case of a return to historical averages for the primary balance, real GDP growth, and real interest rates, the debt ratio would rise over the medium term. The path of the debt-to-GDP ratio is also highly sensitive to the growth assumptions. In the case of a protracted slowdown, with real GDP growth averaging 5 percent, the ratio of debt to GDP would rise over the medium term. A 10 percent of GDP shock to contingent liabilities would sharply raise the debt ratio to 93 percent of GDP, though it would resume its decline after the initial spike.

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

(Public debt, in percent of GDP)



Source: Fund 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/ 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.1. India: Public Sector Debt Sustainability Framework, 2003–2013

(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Baseline: Public sector debt 1/	87.3	87.2	85.2	82.0	80.5	**80.6**	**82.7**	**82.9**	**81.0**	**78.2**	**75.0**
o/w foreign-currency denominated	7.4	6.7	5.9	5.3	5.1	5.3	5.3	5.1	4.9	4.7	4.4
Change in public sector debt	2.4	-0.1	-2.1	-3.2	-1.4	0.0	2.1	0.2	-1.9	-2.8	-3.2
Identified debt-creating flows (4+7+12)	0.3	-3.0	-2.6	-3.8	-4.2	0.1	1.5	0.1	-2.0	-2.9	-3.3
Primary deficit	3.0	1.5	1.6	1.1	0.2	3.8	3.5	2.1	0.7	0.2	-0.2
Revenue and grants	18.7	19.4	19.7	20.9	22.7	21.7	21.2	21.5	22.0	22.6	23.0
Primary (noninterest) expenditure	21.7	20.9	21.3	22.0	23.0	25.5	24.7	23.6	22.8	22.7	22.9
Automatic debt dynamics 2/	-2.4	-4.6	-4.6	-5.7	-5.3	-5.4	-2.0	-2.0	-2.8	-3.1	-3.1
Contribution from interest rate/growth differential 3/	-1.9	-4.3	-4.8	-5.6	-4.8	-5.4	-2.0	-2.0	-2.8	-3.1	-3.1
Of which contribution from real interest rate	3.3	1.8	2.2	1.7	1.9	-0.3	1.7	2.9	2.8	2.6	2.5
Of which contribution from real GDP growth	-5.2	-6.1	-7.0	-7.3	-6.7	-5.1	-3.8	-4.9	-5.6	-5.7	-5.6
Contribution from exchange rate depreciation 4/	-0.4	-0.3	0.2	-0.1	-0.5	...	...	...	...	...	...
Other identified debt-creating flows	-0.4	0.0	0.4	0.9	0.9	1.7	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	-0.5	-0.2	-0.1	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.1	0.3	0.5	0.9	0.9	1.7	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/	2.2	2.9	0.5	0.6	2.8	0.0	0.6	0.1	0.1	0.1	0.1
Public sector debt-to-revenue ratio 1/	466.2	449.3	431.7	392.2	354.6	371.8	390.4	385.7	367.7	346.3	325.4
Gross financing need 6/	9.4	7.7	7.3	6.5	5.9	8.9	9.1	7.7	6.4	5.7	5.2
in billions of U.S. dollars	53.8	51.9	57.2	57.5	65.0	107.9	113.1	103.9	94.7	92.6	92.6
Scenario with key variables at their historical averages 7/						**80.6**	**81.2**	**81.4**	**81.5**	**81.7**	**81.8**
Scenario with no policy change (constant primary balance) in 2008-2013						**80.6**	**80.2**	**80.8**	**80.6**	**80.1**	**79.4**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (in percent)	6.9	7.9	9.1	9.8	9.3	7.3	5.1	6.5	7.5	7.8	8.0
Average nominal interest rate on public debt (in percent) 8/	8.4	8.1	7.6	7.6	7.8	7.7	7.2	7.5	7.7	7.7	7.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.6	2.8	3.2	2.7	3.1	0.2	2.6	4.1	4.1	3.9	3.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	5.3	4.6	-3.3	1.9	12.3	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.8	5.3	4.4	4.9	4.7	7.5	4.7	3.3	3.6	3.8	3.8
Growth of real primary spending (deflated by GDP deflator, in percent)	7.5	4.0	11.2	13.1	14.3	19.0	2.0	1.7	3.7	7.7	8.7
Primary deficit	3.0	1.5	1.6	1.1	0.2	3.8	3.5	2.1	0.7	0.2	-0.2

Source: Fund staff estimates, calendar year data.

1/ General government debt covers central and state governments.

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.

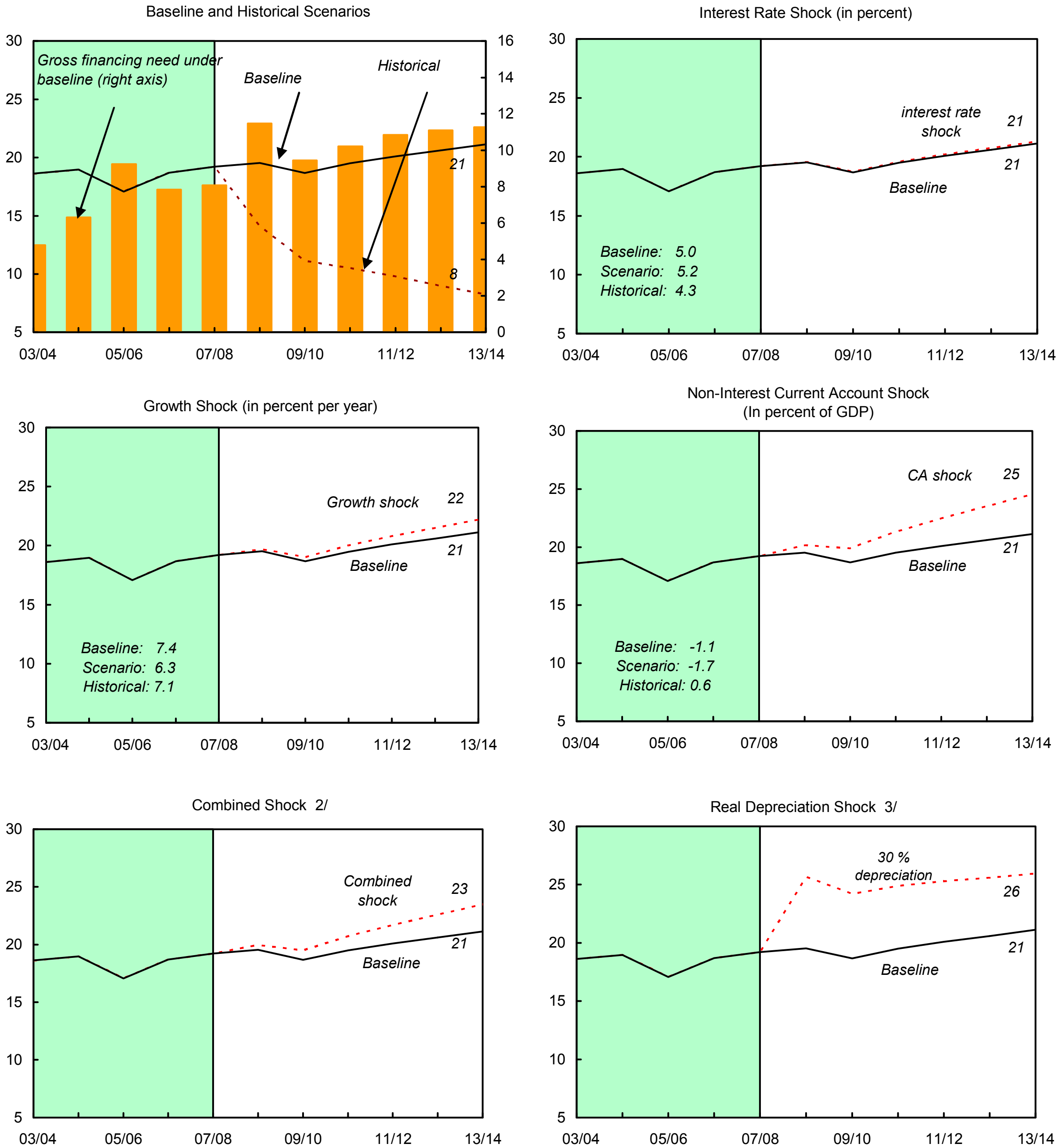
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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.

Figure II.1. India: External Debt Sustainability: Bound Tests 1/

(External debt, in percent of GDP)



Source: Fund 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/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2007/08.

Table II.1. India: External Debt Sustainability Framework, 2004/05–2013/14

(In percent of GDP, unless otherwise indicated)

	Actual				Projections							
	04/05	05/06	06/07	07/08	08/09	09/10	10/11	11/12	12/13	13/14		Debt-stabilizing non-interest current account 6/
Baseline: external debt	19.0	17.1	18.7	19.2	19.5	18.7	19.5	20.1	20.6	21.1		**-3.3**
Change in external debt	0.4	-1.9	1.6	0.5	0.3	-0.9	0.8	0.6	0.5	0.5	0.0	
Identified external debt-creating flows (4+8+9)	-4.1	-3.2	-2.7	-6.1	1.0	-0.4	-1.7	-1.6	-1.5	-1.6	0.0	
Current account deficit, excluding interest payments	-0.3	0.6	0.5	0.7	2.1	0.8	1.4	1.3	1.3	1.3	3.3	
Deficit in balance of goods and services	2.6	3.6	3.4	4.4	5.9	4.2	4.9	5.0	5.0	4.8		
Exports	18.3	20.1	22.3	21.2	23.4	20.5	20.9	21.5	22.3	23.0		
Imports	20.9	23.7	25.7	25.7	29.3	24.7	25.8	26.6	27.2	27.9		
Net nondebt creating capital inflows (negative)	-1.9	-1.9	-1.7	-3.8	-0.7	-0.9	-2.6	-2.6	-2.5	-2.5	-2.5	
Net foreign direct investment, equity	0.5	0.4	0.9	1.3	1.7	1.1	1.5	1.3	1.2	1.2		
Net portfolio investment,equity	1.3	1.5	0.8	2.5	-1.0	-0.2	1.1	1.3	1.3	1.3		
Automatic debt dynamics 1/	-1.9	-1.8	-1.5	-3.0	-0.4	-0.3	-0.4	-0.3	-0.3	-0.3	-0.8	
Denominator: 1+g+r+gr	1.2	1.2	1.1	1.3	1.0	1.1	1.1	1.1	1.1	1.1	1.1	
Contribution from nominal interest rate	0.7	0.6	0.6	0.7	0.8	0.6	0.8	1.0	1.1	1.2	1.2	
Contribution from real GDP growth	-1.3	-1.5	-1.5	-1.3	-1.2	-1.0	-1.2	-1.4	-1.4	-1.5	-1.5	
Contribution from price and exchange rate changes 2/	-1.3	-1.0	-0.6	-2.4	...	...	...	...	...	...	-0.4	
Residual, including change in gross foreign assets (2-3) 3/	4.5	1.3	4.3	6.6	-0.7	-0.4	2.5	2.2	2.1	2.1	0.0	
External debt-to-exports ratio (in percent)	103.5	84.8	83.9	90.5	83.6	91.2	93.4	93.3	92.4	91.7		
Gross external financing need (in billions of U.S. dollars) 4/	44.2	74.7	71.9	94.5	134.6	120.3	140.7	163.6	184.3	205.7		
In percent of GDP	6.3	9.2	7.8	8.1	11.5	9.4	10.2	10.8	11.1	11.2		
Scenario with key variables at their historical averages 5/					14.1	11.1	10.5	9.8	9.0	8.3		-2.2
Key macroeconomic assumptions underlying baseline											For debt stabilization	
Real GDP growth at market prices (in percent)	8.3	9.2	9.7	9.0	6.3	5.3	7.0	7.6	7.9	8.0	8.0	
GDP deflator in US dollars (change in percent)	8.0	5.6	3.3	17.1	-5.7	3.1	1.0	1.8	1.9	2.0	2.0	
Nominal external interest rate (in percent)	4.2	3.9	4.0	4.8	4.1	3.5	4.4	5.9	6.1	6.2	6.2	
Growth of exports goods and services (U.S. dollar terms, in perc	37.9	26.7	25.5	21.6	10.3	-4.7	10.2	13.0	13.8	13.7		
Growth of imports goods and services (U.S. dollar terms, in perc	51.7	30.5	23.0	27.5	14.4	-8.4	13.1	12.7	12.7	12.6		
Current account balance, excluding interest payments	0.3	-0.6	-0.5	-0.7	-2.1	-0.8	-1.4	-1.3	-1.3	-1.3		
Net non-debt creating capital inflows	1.9	1.9	1.7	3.8	0.7	0.9	2.6	2.6	2.5	2.5		
B. Bound Tests												
B1. Nominal interest rate is at historical average plus one standard deviation					19.6	18.7	19.6	20.2	20.8			-3.3
B2. Real GDP growth is at historical average minus one standard deviations					19.7	19.0	20.0	20.8	21.5			-3.3
B3. Non-interest current account is at historical average minus one standard deviations					20.2	19.9	21.3	22.5	23.5			-3.4
B4. Combination of B1-B3 using 1/2 standard deviation shocks					20.0	19.5	20.7	21.7	22.6			-3.3
B5. One time 30 percent real depreciation in 2006					25.7	24.2	24.9	25.3	25.6			-4.5

Source: Fund staff estimates.

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

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + ea(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency (e > 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. Short-term debt includes all the outstanding non-resident deposit accounts.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest 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.

ANNEX III: INDIA—FUND RELATIONS
(As of December 31, 2008)

I. **Membership Status**: Joined 12/27/45; Article VIII.

II. **General Resources Account**	SDR Million	% Quota
Quota	4,158.20	100.00
Fund holdings of currency	3,630.29	87.30
Reserve position in Fund	527.94	12.70

III. **SDR Department**:	SDR Million	% Allocation
Net cumulative allocation	681.17	100.00
Holdings	1.78	0.26

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

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	10/31/1991	06/30/1993	1,656.00	1,656.00
Stand-By	01/18/1991	04/17/1991	551.93	551.93
EFF	11/09/1981	05/01/1984	5,000.00	3,900.00

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

	Forthcoming				
	2009	2010	2011	2012	2013
Charges/interest	5.98	5.62	5.62	5.62	5.62
Total	5.98	5.62	5.62	5.62	5.62

VII. **Exchange Rate Arrangement**:

Since March 1, 1993, the Indian rupee has floated against other currencies, although the Reserve Bank of India intervenes in the market periodically. As per the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER), the exchange rate in India is classified as managed floating with no pre-announced path for the exchange rate. 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 November 2007. The staff report (IMF Country Report No. 07/402) was discussed by the Executive Board on January 23, 2008.

IX. **FSAP Participation and ROSCs**:

The data model of the ROSC was issued in April 2004; FSSA/FSAP report was issued in January 2001; a fiscal transparency ROSC was issued in February 2001.

X. **Technical Assistance**:

Department	Purpose	Date of Delivery
MAE	Government securities market	2/94
MAE	Foreign exchange market	2/95
FAD	Expenditure control	5/95
FAD	Public expenditure management	8/95
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**:

Department	Purpose	Date of Delivery
OAP/APD/ NCAER	Conference: A Tale of Two Giants: India's and China's Experience with Reform and Growth	11/03
FAD	Conference: International Experiences with Fiscal Reform	1/04
APD/FAD	Seminar: Decentralization: International Experiences with Subnational Debt Controls	1/04
APD	Training: Applying Debt Sustainability Templates to Indian States	3/04
APD	Training: Revenue Forecasting	5/05
APD	Seminar: Going Global: India's Emerging Role in the World Economy at Centro di Studi Internazionali sull'Economia e lo Sviluppo	6/06
APD	Book: *India Goes Global: Its Expanding Role in the World Economy*	8/06
APD	Brookings Institution Panel: Is India's High Growth Sustainable?	4/07
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

XI. **Resident Representative**:

A resident representative's office was opened in November 1991. Mr. Sanjaya Panth has been Senior Resident Representative since August 2008.

ANNEX IV: INDIA—RELATIONS WITH THE WORLD BANK GROUP

In Bank FY2008 (July 1-June 30), Bank lending totaled \$2.15 billion, down from \$3.75 billion in FY2007. IFC also recorded a strong commitment in Bank FY2008 of \$1.05 billion. The new World Bank Group's (WBG) Country Strategy (CAS) for India for 2009-2012, discussed with the WBG's Board of Directors on December 11, 2008, focuses on helping India to fast-track the development of much-needed infrastructure and to support the seven poorest states achieve higher standards of living for their people. The strategy envisages a total proposed lending program of US\$14 billion for the next three years, of which US\$9.6 billion is from the International Bank for Reconstruction and Development (IBRD) and US\$4.4 billion (SDR 2.982 billion equivalent at the current exchange rate) from the International Development Association (IDA).

The overarching objective of the new CAS is to scale up the development impact of Bank Group assistance in order to help India move closer to achieving its development goals—including the goal of halving poverty by 2015.

The key thrust of the Bank Group's new CAS strategy will be to provide support to deal with the challenges of achieving rapid, inclusive growth, ensuring sustainable development, and improving service delivery. Scaling up impact will entail a substantially strengthened Bank Group program directed to low-income states, offset by somewhat decreasing shares of lending to the center and other non-lagging states, compared to the prior CAS period. For state level lending, the strategy is to retain an essentially reform and performance-based approach, seeking new opportunities for engagement with the largest and poorest states in order to help strengthen the environment for reform. Through adjustment lending, expected to remain at the current level of approximately 10 percent of total IBRD/IDA lending, continued emphasis is also being placed on support to fiscal and governance reforms at the state level. A major emphasis of the new CAS will be on strengthening weaknesses in project implementation, with a cross-cutting focus on improving the effectiveness of public spending and achieving demonstrable results to scale up the impact of World Bank assistance. IFC's FY09-11 strategy, centering on improving inclusion, managing the impact of climate change, and promoting regional integration, is closely aligned to the Bank's.

Financial operations since 2001/02 are summarized below.

India: World Bank Group Financial Operations

(In millions of U.S. dollars)[1/]

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Commitments 2/	2,830	2,092	1,328	2,705	1,886	2,451	3,174
IBRD	1,904	951	698	1,463	1,241	1,566	1,932
IDA	926	1,141	630	1,242	645	855	1,242
Disbursements	1,997	1,533	1,816	1,835	2,135	1,935	1,904
IBRD	803	647	892	818	938	947	1,092
IDA	1,195	886	924	1,017	1,197	988	812
Repayments	1,147	3,491	2,403	784	842	946	1,086
IBRD	724	3,031	1,871	201	221	282	363
IDA	424	460	532	582	621	664	723
Debt outstanding and disbursed	26,466	26,243	27,019	28,527	28,925	30,911	33,552
IBRD	7,010	5,082	4,238	4,865	5,557	6,277	7,040
IDA	19,456	21,161	22,781	23,662	23,368	24,634	26,512

Source: World Bank.

1/ On a fiscal year basis beginning April 1.
2/ Based on loan approval date.

ANNEX V: INDIA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK

The Asian Development Bank (AsDB) operations in India began in 1986. Cumulative public sector loan commitments totaled $19.2 billion as of 31 December 2008 for 112 loans. With an additional $1.6 billion in private sector loans (the latter without government guarantee), total loan commitments on a cumulative basis amount to $20.8 billion. These funds have been provided from the Bank's ordinary capital resources (OCR). Also, AsDB has approved equity investments amounting to $0.2 billion. AsDB's lending and equity activities are summarized below.

India: Asian Development Bank Financial Operations

(In millions of U.S. dollars, as of 31 December 2008)

Calendar Year	OCR Loan Commitments	Private Equity	Disbursements
1986–90	2,317.6	10.9	338.7
1991–95	3,364.0	59.5	2,131.3
1996	763.0	--	591.7
1997	563.0	15.5	645.0
1998	250.0	--	620.4
1999	625.0	--	605.3
2000	1330.0	--	487.0
2001	1,500.0	--	269.9
2002	1,163.6	25.0	576.5
2003	1,411.0	0.7	658.0
2004	1,200.0	29.7	381.4
2005	367.3	15.0	641.0
2006	1,260.0	67.6	701.4
2007	1,232.1	--	1,363.5
2008	1,808.3	18.6	1509.9
Total	19,154.9	242.3	11,521.0

Source: Asian Development Bank.

AsDB is currently preparing its India Country Partnership Strategy (CPS) for 2009–12. The proposed strategy will have four strategic pillars. These include: (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 proposed strategy will focus on key infrastructure sectors such as transport (national highways, state roads, and rural roads), energy (power sector reforms, strengthening transmission and distribution system, hydropower generation, and improvement in energy efficiency), urban (water supply and sanitation, waste management, urban transport, and municipal reforms), and agriculture and natural resource management (irrigation). The proposed strategy will also support the key thematic concerns of environmental sustainability, private sector development and private sector operations, governance and capacity building, gender equity, knowledge solutions, and partnerships during the CPS period.

ANNEX VI: INDIA—STATISTICAL ISSUES

1. Macroeconomic statistics are adequate for surveillance, but weaknesses remain in the timeliness and coverage of certain statistical series. India has an elaborate system for compiling economic and financial statistics and produces a vast quantity of data covering virtually all 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**: The Central Statistical Organization (CSO) has recently reduced the dissemination lag for quarterly releases from three to two months and released a new series of national accounts, with base year 1999–2000 in February 2006. 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).

4. **Price statistics**: The consumer price indices (CPIs) are based on weights that are over ten years old and do not fully capture price developments in the economy. However, since January 2006, the Labour Bureau has published a revised CPI for industrial workers with a 2001 base year and a Working Group is engaged in the revision of the current producer price index to a new base. Presently, there are four CPIs, each based on the consumption basket of a narrow category of consumers (namely industrial workers, urban and nonmanual employees, agricultural laborers, and rural laborers). The CPIs are published with a lag of about one month. A WPI (1993/94=100) is published weekly with a lag of two weeks and is subject to large revisions, especially in periods of rising inflation. In addition, the representativeness of the index may be undermined by the collection of prices from a relatively small sample of products and the infrequent updating of weights.

5. **External sector statistics**: While the concepts and definitions used to compile balance of payments statistics are broadly in line with the fifth edition of the *Balance of Payments Manual (BPM5)*, the RBI presentation does not strictly follow the *BPM5*. 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 *BPM5* and these data are disseminated within six months of the reference period in respect of annual data. 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. 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 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. **Fiscal operations**: The Ministry of Finance (MoF) posts selected central government monthly fiscal data and quarterly debt data on its web site. However, no monthly data on fiscal performance at the state level are available, and annual data are available only with an 8-month to 10-month lag. Consolidated information is unavailable on local government

operations. In addition, 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* (latest reported data correspond to 2006). Some limited general government data has been reported for 2002.

India—Table of Common Indicators Required for Surveillance

As of January 7, 2009

	Date of latest observation	Date received	Frequency of Data 1/	Frequency of Reporting 1/	Frequency of Publi-cation 1/	Memo Items 2/ Data Quality–Methodological soundness 2/	Data Quality–Accuracy and reliability 3/
Exchange rates	01/7/09	01/7/09	D	D	D		
International reserve assets and reserve liabilities of the monetary authorities 4/	12/26/08	01/2/09	W	W	W		
Reserve/base money	12/26/08	01/2/09	W	W	W	O, O, LO, LO	O, O, O, O, O
Broad money	12/19/08	01/2/09	BW	BW	W		
Central bank balance sheet	Jun. 08	08/30/08	A	A	A		
Consolidated balance sheet of the banking system	Mar. 08	10/1/08	A	A	A		
Interest rates 5/	01/7/09	01/7/09	D	D	D		
Consumer price index	Nov. 08	01/2/09	M	M	M	O, LNO, O, O	LNO, LO, O, O, O
Revenue, expenditure, balance and composition of financing 6/ – General Government 7/	Mar. 08	10/01/08	A	A	A	LNO, LO, O, O	O, O, O, O, LO
Revenue, expenditure, balance and composition of financing 6/ – Central Government	Nov. 08	01/2/09	M	M	M		
Stocks of central government and central government-guaranteed debt 8/	Mar. 08	10/01/08	A	A	A		
External current account balance	Jul-Sep. 08	01/5/09	Q	Q	Q	LO, O, LO, O	LO, O, O, O, LO
Exports and imports of goods and services	Jul-Sep. 08	01/5/09	Q	Q	Q		
GDP/GNP	Jul-Sep. 08	12/18/08	Q	Q	Q	LO, LNO, LO, LO	LNO, LNO, O, O, LO
Gross external debt	Jul-Sep. 08	01/5/09	Q	Q	Q		

1/ Daily (D), Weekly (W), Biweekly (BW), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
2/ Reflects the assessment provided in the data ROSC (published on April 2, 2004, and based on the findings of the mission that took place during May 13–30, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
3/ Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies
4/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
5/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
6/ Foreign, domestic bank, and domestic nonbank financing.
7/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state governments.
8/ Including currency and maturity composition.

Statement by the IMF Staff Representative on India
February 6, 2009

1. This statement contains information that has become available since the staff report was circulated to the Executive Board on January 23, 2009. This information does not alter the thrust of the staff appraisal.

Economic and financial developments

2. **Indicators of economic activity have remained soft.** While exports (in dollar terms) contracted by 1 percent y/y in December, better than the 11 percent contraction recorded in October-November, based on preliminary shipment data the government announced that January exports will likely decline by 22 percent. Furthermore, the commerce ministry now expects exports to fall in 2009/10. Finally, the manufacturing sector PMI (ABN Amro) indicated continued contractions in output, new orders, and employment in January, although at a slower pace than in December.

3. **Inflation continues to fall on the back of lower fuel prices**. WPI inflation decelerated to an average 5.5 percent (y/y) during the first three weeks of January compared to 5.9 percent (y/y) in December. The three-month moving average of WPI changes remained negative. Consumer price inflation (industrial workers) has also decelerated but remains high at 9.7 percent (y/y) in December.

4. **Tax collections have continued to weaken.** During April-December, they rose only 5 percent (y/y), compared to 26 percent (y/y) for the April-September period. With expenditure also rising faster than projected, further market borrowing will likely be announced in February. In its January review, the Prime Minister's Economic Advisory Council forecast that the 2008/09 general government fiscal deficit (including subsidy-related bonds) at about 10 percent of GDP, the same as projected by staff.

5. **Overall credit growth is decelerating, but public banks' credit has picked up and lending rates have declined somewhat.** The growth of non-food credit to the private sector slowed to 23 percent y/y in mid-January and was negative in seasonally adjusted, month-on-month terms. Recently published data show that lending has differed significantly by bank ownership. While total lending during 2008 rose by 21 percent, that of private and foreign banks slowed sharply to 12 percent and 17 percent, respectively, while that of public sector banks rose to 29 percent. Commercial lending rates remain much higher than the policy rate, though reductions are starting to occur, particular in state-owned banks.

6. **Recent financial results suggest that banks' profits are holding up well, but corporates performance is weakening.** Earnings for the September-December 2008 quarter held up reasonably well with SBI and ICICI reporting increases of 51 percent and 3.4 percent in their consolidated profits. These results exceeded market expectations, but were less than in the same period last year. Reflecting these results and in line with global trends, the CDS

spreads on these banks have declined by about 30-80 basis points compared to end-December. In contrast, corporate profits have continued to decline: a sample of about 2,400 companies indicates that after-tax profits declined by 8 percent y/y in the June-September quarter. Initial results for the October-December quarter and corporate tax revenue suggest continued weak performance.

7. **Financial markets have stabilized, but remain volatile.** The equity market declined about 5 percent during January, while the rupee/U.S. dollar rate held steady at about 49. In credit markets, commercial paper rates have eased somewhat. The yield curve for government securities has steepened with long yields rising in recent weeks (by about 50-100 bps), reflecting expectations of significant debt issuance. Portfolio investment registered net outflows of about $1 billion in January, and reserves fell by $2.8 billion to US$248 billion as of January 23, 2009 compared to end-December.

Policy developments

8. **The Reserve Bank of India (RBI) kept monetary policy on hold at its quarterly policy meeting on January 27.** The central bank cut its GDP growth forecast to 7 percent for 2008/09 (from the 7½-8 percent range announced at the last quarterly meeting), noting that downside risks have increased. It also reduced its forecast for headline inflation (WPI) for end-March to below 3 percent (y/y), from 7 percent previously. In explaining its decision to leave policy rates unchanged, the RBI noted that CPI inflation has yet to moderate and that liquidity in the financial system is already ample. It also noted delays in the transmission from policy to commercial bank rates. Looking ahead, the authorities expressed their desire to keep some measures in reserve, while indicating its readiness to act if the situation worsens. On the liquidity front, the RBI extended its facility for banks to onlend to mutual funds, non-bank financial corporations, and housing finance companies from June to September 2009.

9. **On January 29, the government reduced the prices of gasoline, diesel, and LPG by an average 8 percent.** The direct impact of these cuts on WPI inflation is estimated at about 0.4 percentage point. At present gasoline and diesel prices are in line with international comparators, while those for LPG and kerosene remain about 60 and 120 percent higher, respectively, than international prices.

10. **The government has announced that it will not bail out private companies.** In contrast to financial institutions, which are subject to regulation, the authorities have emphasized that a private company producing goods or services, competing in a competitive market should not be treated on the same basis as banks.

11. **On January 23, 2009, the authorities announced a 6-month ban on imports of toys from China.**

INTERNATIONAL MONETARY FUND
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Public Information Notice (PIN) No. 09/35
FOR IMMEDIATE RELEASE
March 17, 2009

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

IMF Executive Board Concludes 2008 Article IV Consultation with India

On February 6, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with India.[1]

Background

After five years with average growth of 8¾ percent, India's economy is slowing. On February 9, 2009, the Central Statistical Organization released advanced estimates for 2008/09 (April-March) real GDP growth of 7.1 percent. Partly reflecting the deteriorating global outlook, staff project India's growth to moderate to 6¼ percent in 2008/09 and further to 5¼ percent in 2009/10. Corporate investment—the major growth driver during recent years—is expected to slow because of weakening profitability and confidence, and tightening of financing conditions from foreign and nonbank sources. Policy measures to stimulate the economy and a good harvest should support domestic demand. The uncertainty surrounding the forecast is unusually large, with significant downside risks. The main upside risk stems from a larger-than-anticipated impact of the stimulus measures that the authorities have already implemented.

After rising to nearly 13 percent (year-on-year) in August 2008, headline inflation (Wholesale Price Index) dropped to 4.4 percent (y/y) at the end of January 2009. With commodity prices waning and demand slackening, inflation is expected to fall further to 3 percent (y/y) by March 2009 and to 2 percent on average in 2009/10.

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[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.

The current account deficit is projected at about 3 percent of GDP in 2008/09, primarily due to a markedly higher oil import bill. While export performance has deteriorated sharply in recent months, softer import growth is keeping the trade deficit in check. For 2009/10, the current account deficit is forecast to narrow to 1½ percent of GDP, reflecting lower oil prices and weaker domestic demand.

After last year's record of 9.2 percent of GDP, capital inflows are expected to decline this fiscal year; until December 2008 portfolio investment recorded a US$11 billion outflow and external commercial borrowing has slowed considerably, though there has been a mild recovery in portfolio investment since October 2009 and foreign direct investment (FDI) has held up relatively well. While reserves have declined this fiscal year, from a historic peak of US$315 billion in May 2008 to US$252 billion as of February 6, 2009, they remain adequate compared to the country's gross financing requirement and imports.

As a result of the global crisis, the stock market index declined by over 50 percent in 2008 and the rupee depreciated 23 percent versus the U.S. dollar and 13 percent in nominal effective terms. The real effective exchange rate depreciated by 10 percent and is in line with its equilibrium value. In early 2009, however, the rupee and the stock market have stabilized somewhat.

The Reserve Bank of India's (RBI's) measures—including cutting policy rates, lowering the cash reserve ratio and the statutory liquidity ratio, and easing controls on capital inflows—have eased the domestic liquidity pressures that appeared in September and October and brought down interbank rates significantly. Nevertheless, the TED[2] and commercial paper spreads remain elevated and commercial lending rates have fallen much less than policy rates. Given the rapid decline in inflation, this means that real interest rates have actually increased over the past months. Credit growth remains relatively high, though this in part reflects the switch of corporate funding to banks as financing from other sources has declined.

Banks, which dominate the financial system, appear well-capitalized, relatively liquid, and have low non-performing assets (NPA) ratios. However, over the last few years, an increase in foreign liabilities, combined with rapid domestic credit expansion, has increased banks' vulnerability to global deleveraging and slowing economic activity. Consequently, their share prices have fallen sharply and their credit default swap (CDS) spreads and default probabilities have risen. Mutual funds faced significant redemptions in September, and other nonbank financial institutions face a marked increase in borrowing costs.

Although the 2008/09 budget targeted further consolidation in line with the previous five years, spending rose sharply even before the onset of the crisis, reflecting a soaring subsidy bill,

[2] The TED spread is the difference between the 3-month Mumbai interbank offer rate (MIBOR) and 3-month Indian Government Treausury bill yield.

agricultural debt forgiveness, an expansion of a rural employment guarantee scheme, and a 21 percent civil service wage hike. In addition, tax revenue has slowed sharply as the economy is losing steam. Staff project the central government deficit at about 7 percent of GDP this year, including 1¼ percent of subsidy-related bond issuance. The general government deficit, which includes the states' deficit, is forecast to rise to nearly 10 percent of GDP. Public debt remains elevated at about 80 percent of GDP. On February 16, 2009, the government issued the 2009/10 interim budget, which targets a reduction in the central government headline deficit of ½ percentage point of GDP.

Executive Board Assessment

Executive Directors commended India's strong economic performance in recent years, which reflected sound macroeconomic policies and continued progress with structural reform. They noted that India confronts the current global economic and financial crisis from a position of strength.

Directors observed, however, that there have been spillovers from the global crisis. They commended the authorities' swift and comprehensive policy response, but underscored the downside risks and called for maintenance of a flexible, pragmatic, and proactive policy stance. Directors agreed that a key short-run policy objective should be to sustain liquidity and credit flows. They believed that monetary and structural policies will have to continue to carry most of the burden of adjustment, given the high public debt-GDP ratio.

Directors welcomed the central bank's actions to ease monetary policy and stimulate bank lending. A number of Directors saw scope for further monetary easing, in light of the projected decline in inflationary pressures and the need to reinforce confidence and sustain bank credit. However, a number of other Directors saw merit in the authorities' wait-and-see approach, given the highly uncertain economic environment.

Directors supported the authorities' flexible exchange rate policy, which will help the economy to adjust to the global downturn. They underscored that exchange market intervention should be consistent with the goal of ensuring sufficient domestic liquidity, and concurred that international reserves should be conserved to relieve concerns about external financing. At the same time, a number of Directors were not in favor of letting the exchange rate find a floor if depreciation pressures re-emerge, stressing the risk of overshooting in times of financial volatility and uncertainty. Directors noted the staff's conclusion that the exchange rate appears to be close to its estimated equilibrium level.

Directors commended the strength and resilience of India's financial system, reflected in favorable financial soundness indicators. However, they stressed that rising credit risk and liquidity pressures could put the financial system under strain, while negative feedback loops between the real and financial sectors could turn out to be strong. Directors therefore encouraged the authorities to take additional preventive action, including identification of potential bank re-capitalization needs and measures to promote early loss recognition, full disclosure of bad assets, and filling of information gaps. They underscored the importance of persevering with reforms to deepen and further strengthen the financial sector, develop the corporate bond market, and improve banking efficiency.

Directors broadly supported the authorities’ gradual and cautious approach to capital account liberalization. They encouraged further progress, observing that liberalization could help to ease external financing constraints. Directors also welcomed the authorities’ commitment to trade liberalization.

Directors considered that, while corporate balance sheets have been strong in recent years, slowing economic growth and tighter financing conditions could increase corporate distress. They encouraged the implementation of reforms to strengthen corporate governance and the regulatory framework for corporate restructuring. These measures are also important to improve the investment climate.

Directors acknowledged that the sizeable fiscal stimulus undertaken in 2008-09 should help to support economic growth. However, they stressed that, given the high ratio of public debt to GDP, significant further expansion of the deficit could raise concerns about fiscal sustainability. They encouraged the authorities to use the limited available fiscal space only for high-quality infrastructure and poverty-related spending, and for bank recapitalization if needed. They advised that any further short-term stimulus be combined with fiscal reforms to safeguard medium-term debt sustainability. In this connection, they encouraged the authorities to take advantage of falling international fuel prices by moving expeditiously with their fuel subsidy reform plan, while ensuring that a well-targeted social safety net is in place.

Directors stressed that medium-term fiscal consolidation remains a priority, and should continue to be anchored in a fiscal rules framework. They were encouraged that the authorities are considering a strengthened successor fiscal framework to replace the existing one when it expires in 2009-10. Directors called for the new framework to be backed by comprehensive expenditure reforms and measures to broaden the tax base.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

India: Selected Economic Indicators, 2004/05–2009/10 1/

	2004/05	2005/06	2006/07	2007/08	2008/09 2/ Proj.	2009/10 2/ Proj.
Growth (y/y percent change)						
Real GDP (at factor cost)	7.5	9.4	9.6	9.0	6.3	5.3
Non-agricultural sector	9.5	10.3	11.0	10.0	7.1	5.9
Industrial production	8.4	8.2	11.5	8.5	...	...
Prices (y/y percent change, period average for annual data)						
Wholesale prices (1993/94 weights)	6.5	4.4	5.4	4.7	8.8	1.9
Consumer prices - industrial workers (2001 weights)	3.8	4.4	6.7	6.2	7.8	3.4
Saving and investment (percent of GDP)						
Gross saving 3/	31.8	34.3	34.8	36.0	34.6	34.9
Gross investment 3/	32.2	35.5	35.9	37.5	37.6	36.4
Fiscal position (percent of GDP) 4/ 5/						
Central government deficit	-4.1	-4.7	-4.4	-3.4	-7.1	-5.7
General government deficit	-7.3	-7.3	-6.3	-5.8	-9.9	-8.8
General government debt	86.5	84.2	80.6	80.1	80.7	82.9
Money and credit (y/y percent change, end-period)						
Broad money	12.3	21.2	21.5	20.8	…	…
Credit to commercial sector	26.0	32.2	25.8	20.6	…	…
Financial indicators (percent, end-period)						
91-day treasury bill yield	5.3	6.1	8.0	7.2	…	…
10-year government bond yield	6.7	7.5	8.0	7.9	…	…
Stock market (y/y percent change, end-period)	16.1	73.7	15.9	19.7	…	…
External trade 6/						
Merchandise exports (US$ billions)	85.2	105.2	128.9	166.2	186.4	169.0
y/y percent change	28.5	23.4	22.6	28.9	12.2	-9.4
Merchandise imports (US$ billions)	118.9	157.1	190.7	257.8	298.0	265.5
y/y percent change	48.6	32.1	21.4	35.2	15.6	-10.9
Net oil imports (US$ billions)	22.9	32.3	38.3	52.2	60.0	38.6
Balance of payments (US$ billions)						
Current account balance	-2.5	-9.9	-9.6	-17.0	-35.1	-18.6
(in percent of GDP)	-0.4	-1.2	-1.0	-1.5	-3.0	-1.5
Foreign direct investment, net	3.7	3.0	7.7	15.4	19.9	14.0
Portfolio investment, net (equity and debt)	9.3	12.5	7.1	29.6	-11.7	-2.5
Overall balance	26.2	15.1	36.6	92.2	-27.9	-3.3
External indicators						
Gross reserves (in billions of U.S. dollars, end-period)	141.5	151.6	199.2	309.7	246.8	243.5
(In months of imports) 7/	8.9	7.7	7.7	10.5	9.1	8.0
External debt (in billions of U.S. dollars, end-period) 8/	133.0	138.1	171.4	224.8	229.0	238.0
External debt (percent of GDP, end-period) 8/	19.0	17.1	18.7	19.2	19.5	18.7
Of which: short-term debt 9/	4.6	3.3	3.8	7.3	7.6	7.9
Ratio of gross reserves to short-term debt (end-period) 9/	4.4	5.6	5.7	3.6	2.8	2.4
Gross reserves to broad money (percent; end-period)	27.5	24.8	26.1	31.0	28.9	...
Debt service ratio 10/	6.0	10.1	4.9	5.3	5.5	5.7
Real effective exchange rate 11/						
(y/y percent change, period average for annual data)	2.2	4.4	-2.2	8.2	…	…
Exchange rate (rupee/US$, end-period)	43.7	44.6	43.5	40.1	…	…
Memorandum items (in percent of GDP):						
Subsidy related bond issuance 12/	0.0	0.5	1.0	0.6	1.3	0.3

Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; Bloomberg L.P.; *World Development Indicators*; and Fund staff estimates and projections.
1/ Data are for April-March fiscal years.
2/ Current staff projections.
3/ Differs from official data, calculated with gross investment and current account. Gross investment includes errors and omissions.
4/ Divestment proceeds treated as below-the-line financing.
5/ Subsidy related bond issuance included in total expenditure.
6/ Annual data are on balance of payments basis.
7/ Imports of goods and services projected over the following twelve months.
8/ For projection, data are reported relative to staff's estimated annual GDP.
9/ Including short-term debt on contracted maturity basis, NRI deposits due within one year, and medium- and long-term debt on residual maturity basis.
10/ In percent of current account receipts excluding grants.
11/ IMF INS calculation.
12/ Issued by the central government to FCI, the state-owned oil refining/distribution companies, and fertilizer companies as compensation for losses incurred from the provision of subsidies.

Statement by Adarsh Kishore, Executive Director for India, Michael D. Patra, Senior Advisor to Executive Director and Partha Ray, Advisor to Executive Director February 6, 2009

1. The set of staff papers gives an assessment of the outlook for the Indian economy and also presents the views of the authorities on a number of important issues, including some on which there are significant differences in perception and policy diagnosis. The authorities consider the staff assessment to be unduly pessimistic on various fronts.

The Real Economy and the Outlook for Growth

2. The Indian economy has moved closer to its potential growth than ever before, clocking 8.8 per cent per annum on average over the last five years. This period is also characterized by a rapid integration into the global economy. The recent growth experience has, however, been driven largely by domestic consumption and investment, even as the share of net exports rose. India cannot be expected to remain immune to the ongoing global crisis and just like other economies, mature and emerging, the outlook is overcast by heightened uncertainty. While the Indian authorities have consistently ruled out any decoupling, it is important to recognize that there are some positive features that distinguish India's experience and should work as built-in stabilizers.

Lead Indicators

3. Lead indicators suggest that agricultural production during 2008-09 may be close to or better than last year's record production. Industrial production has slackened considerably when compared with the ebullient performance a year ago but is still growing at close to 4 per cent on a year-on-year basis up to November 2008 (the latest period for which data are available). In fact, sustained performance of the agricultural sector, fiscal stimulus, falling global crude oil prices and softening of domestic input prices of energy, cement and steel are likely to have a positive impact on industrial production in the coming months. Activity in the Service sector appears to be moderating, but is likely to regain its momentum as the upturn begins. Sub-sectors like railway freight traffic and communication have already commenced their pick-up.

Outlook

4. There is some convergence of views between the staff and the authorities in the assessment that the economy is undergoing a cyclical moderation accentuated by the combined impact of the global downturn and the ongoing financial crisis. On the near-term outlook, the difference between the 'pessimism' of the staff assessment and the 'cautious optimism' of the authorities' view is essentially one of degree and not of direction. At the current juncture, the authorities expect real GDP during 2008-09 to grow at 7.0 per cent, with a downward bias.

5. In the medium-term, there is near-unanimity – that inherent fundamentals are strong and intact, and demographic dividend, institutional infrastructure, strength of domestic demand, growing entrepreneurial spirit, rise in productivity and untapped growth potential would return the Indian economy to its high growth trajectory. Indeed, the authorities believe that

once the global economy begins to recover, India's turnaround will be sharper and swifter. What India is facing today is not a loss of growth but merely a moderation of speed.

Corporate Sector

6. It is important to recognize that the corporate sector is dealing with the crisis from a much stronger position than it was in earlier downturns. Since 2003, the corporate sector has restructured and refocused its strategies, stood up to foreign direct investment and liberalized imports including of technology and developed a competitive edge and a global scan. Empirical studies show that from 2002-03 onwards, an improvement in productivity and efficiency is taking hold. This has also been reflected in the steady and consistent jump in profitability with growth in post-tax profits in the range of 20-40 per cent since the second half of 2002-03 right up to March 2008 and the moderation in profitability growth thereafter needs to be viewed as a cyclical ebb rather than a structural deterioration.

7. While the downside risk to corporate profitability may have increased in the current global slowdown, this could be partly offset by falling input prices and a gradual reduction in borrowing costs. Moreover, as noted earlier, improvements in industrial production could have a conducive effect on corporate performance in the period ahead.

Monetary Policy

8. There has been a swift change in the monetary policy stance during 2008-09 – from fighting the upsurge in inflation on the back of soaring international commodity prices in the first half of the year to dealing with the combined impact of the global financial crisis and the follow-on global economic downturn. In the second phase, the objectives have been: to ensure orderly functioning of the domestic financial markets in contrast to the freezing up of money and credit markets in the mature economies; to ensure that liquidity did not become a binding constraint on financial institutions; to keep credit flowing to productive sectors of the economy; and to preserve financial stability and ensure that confidence in the financial system is maintained and the institutions themselves are able to intermediate the financing requirements of the growth process.

9. By and large, the authorities have succeeded in these objectives. At a time when international financial markets seized up and capital flows dwindled and even reversed, the Indian banking sector showed resilience in accommodating both substitution effects and the tightening of financing constraints in some sectors such as mutual funds and non-banking finance companies. Thus, bank credit disbursement actually accelerated on a year-on-year basis with the growth (yoy) in non-food bank credit at 23.1 percent as on January 16, 2009 being higher than that of 22.1 percent as on January 18, 2008. This acceleration of bank credit made up for the drying up of other resources – so much so that during 2008-09 so far (till January 2, 2009), the total flow of resources to the commercial sector from banks and other sources was only marginally lower than in the previous year (Rs. 4847 billion this year as against Rs. 4995 billion last year) and the gap was more than bridged by companies' recourse to internal accruals. There has, however, been a noticeable variation in credit expansion across bank groups. Credit expansion by foreign and private sector banks was significantly lower than a year ago and has been more than compensated for by expansion of credit by public sector banks.

Policy Measures

10. Measures aimed at expanding rupee liquidity have resulted in liquidity support of the order of 7 per cent of GDP and the authorities stand ready to do more, if warranted, to achieve the objectives indicated earlier. In January 2009, a special purpose vehicle (SPV) was set up for addressing the temporary liquidity constraints of systemically important non-deposit taking non-banking financial companies. The policy rates i.e., the repo and reverse repo rates under the LAF have been cut by 350 basis points and 200 basis points respectively to historically lowest levels accompanied by appropriate forex intervention. It is important to note that the authorities have undertaken these measures without diluting the quality of collateral accepted by the Reserve Bank.

11. Managing forex liquidity included a firm reassurance by the Reserve Bank to meet any demand supply gaps of foreign exchange in the domestic foreign exchange market, introduction of a forex swap facility (of tenor up to three months) by the Reserve Bank for Indian public and private sector banks with overseas branches or subsidiaries (for funding the swap, banks were allowed to borrow under LAF for the corresponding tenor at the prevailing repo rate), upward adjustment of the interest rate ceilings on the deposits of non-resident Indians, substantial relaxation of the regime for external commercial borrowing, allowing non-banking finance companies / housing finance companies access to foreign borrowing and allowing corporates to buy back foreign currency borrowing to take advantage of the discount in the prevailing depressed global markets.

12. These measures restored normalcy in the money and credit markets swiftly. Bank deposit and lending rates, which had firmed up during the current financial year up to October 2008, started easing from November 2008. In this context, the authorities remain mindful of the dangers of getting locked into a liquidity trap and its consequences in some countries. Thus further interest rate reductions may not be in the interest of ensuring the effectiveness of monetary policy or of the long-term aspirations of growth.

Financial Sector Issues

13. The soundness of the financial sector is among the strengths with which India prepares for the difficult and challenging period ahead. Underlying this favourable position is the approach that has been followed over nearly two decades of reforms – instituting global standards alongside country-specific norms. Also the pace of reform has been carefully calibrated to the size of the change and preparedness of domestic institutions, and generally a big-bang approach has been avoided. This approach has stood India in good stead through two decades marked by financial crises in various parts of the world. While the level of innovation in terms of exposure to structured products and complex derivatives may be low, the overall soundness of the system has been preserved.

14. This approach has forewarned and equipped the financial system and the regulatory authorities for dealing with the inevitable rise in non-performing assets and credit risks in periods of economic downturn. In some sectors, counter-cyclical prudential measures – increase in risk weights and provisioning - taken in the past periods when credit growth was rapid, have been scaled back in view of the current macroeconomic, monetary and credit conditions and consistent with the practice of dynamic provisioning. Where pockets of

financial stress have been indicated through early detection tools, the authorities have moved swiftly and decisively to ease liquidity/funding stress and to initiate corrective processes for duration and asset-liability mismatches, as in the case of non-banking financial companies (NBFCs) and mutual funds (MFs).

15. The authorities have announced plans to recapitalize banks and have expressed a readiness for further measures in case of emergence of any symptom of deterioration in asset quality.

Development of Corporate Bond Market

16. The development of a corporate bond market is conditional upon reforms on the demand and supply sides. On the demand side, reforms in the institutional investor base – pension reforms – are awaiting legislative approval. Introduction of repo in corporate bonds has been recommended by a High Level Expert Committee on Corporate Bonds and Securitization to enhance market liquidity. The Reserve Bank has indicated that the introduction of repos in corporate bonds would require greater public issuances and secondary market trading. Another key ingredient is depth and liquidity and for this purpose, further deepening of the government securities market is vital. It is in the context of these prerequisites that corporate bond markets have not developed in many countries. It may be mentioned that the limit on Foreign Intuitional Investment on corporate debt instruments has been raised recently to US $ 15 billion. The limit has not been fully used by the FIIs.

External Sector

17. It may be noted that India's modest current account deficit has not been contributing to global imbalances. At the same time, external debt is sustainable and low. India's current account deficit (CAD) did widen in the first half of 2008-09 ($ 22.3 billion), but this was episodic and reflecting high oil and commodity prices, even as private transfers and software export earnings were sustained. As net capital flows declined in the wake of a global risk aversion and perceived flight to safety, the overall balance of payments position turned marginally negative during the first half of 2008-09 but was comfortably financed by drawing from the large stock of international reserves. Import growth moderated during October-November 2008 reflecting the fall in international oil prices. Going forward, it is expected that imports may slow down faster than exports. Portfolio outflows have moderated and intermittent inflows have been observed during December 2008 and January 2009. Accretion to non-residents deposits are bolstering the capital account. Foreign direct investment is higher than the level a year ago and there is no evidence so far of any slackening of pace. The volume of proposals already received suggest, in fact, that a further pick-up cannot be ruled out in 2009 if stability is restored in the global financial system. Net capital flows were positive in 2008 largely financing the current account deficit and are expected to continue to do so in 2009. Thus, the stress on the BoP seems to be temporary and a return to normalcy is already underway. At the current juncture, the level of forex reserves is holding at the level prevailing in October 2008 and there is ample cover for imports / debt-service payment for a full year. Looking ahead, the authorities fully recognize risks to the BoP in 2009-10, emanating from weaker export growth and subdued capital flows. The onset of global recovery and improvement in world trade will ease the pressure on the external sector.

Exchange Rate

18. The rupee had appreciated against major currencies in 2007-08 due to large capital inflows. It depreciated during September and October, 2008 reflecting extraordinary developments in international financial markets and portfolio outflows by foreign institutional investors (FIIs), and has remained range-bound since November 2008. Movements in the exchange rate have been self-equilibrating and would continue to be so under the current exchange rate regime. The exchange rate remains fairly valued giving a fillip to competitiveness. The authorities are committed to managing volatility without defending any level of the exchange rate, thereby promoting financial stability.

Approach to Capital account liberalization

19. Capital account liberalization is viewed by the authorities as a means of integrating the Indian economy into the world and substantial progress has been made in this regard. Global evidence does not support the case for full liberalization of the capital account. The authorities hold that capital account liberalization is a process, not an event. The policy approach is one of a hierarchy in which foreign investment flows have been virtually freed except in strategic sectors while a more prudent approach has been adopted for debt-creating flows. The benefits from reliance on debt flows are unclear. Past crises have clearly demonstrated the vulnerability associated with volatile, short-term, foreign-currency denominated debt flows. The Indian policy approach is based on this framework, and has helped the country in the pursuit of growth acceleration while maintaining financial and macroeconomic stability. In view of the lessons drawn from various international crises, a need has been felt to retain some instruments for regulating the flow of capital in tune with the absorptive capacity of the economy and the preparedness of financial markets and intermediaries. The relevance of further opening up to foreign inflows needs to be considered with a fuller appreciation of this approach, especially in the current context.

Fiscal policy

20. We broadly agree with the staff's assessment of a deterioration in the fiscal position that is turning out to be weaker than initially anticipated. The cyclically induced discretionary fiscal measures – first in the context of the surge in inflation driven by international commodity prices in the first half of 2008 and subsequently, the fiscal stimulus that became common across countries as the global slowdown deepened – account for erosion in Central public finances. In the event of the global downturn becoming deeper and more protracted as prognosticated in the January 2009 update of the WEO, the burden on the fisc could increase further and diffuse across general government.

21. There are significant downside risks associated with this scenario. *First*, as the authorities world over mount fiscal policy action to defend their economies against the headwinds of the global slowdown, the prospects of recovery could recede further in time as the private sector and even the public sector in the emerging world face financial crowding out. *Second*, the staff does well to cite the limited room for fiscal maneuver, given a general government deficit of close to 10 per cent of GDP and a public debt of nearly 77 per cent of GDP. This is unfortunately a situation which various countries, mature and emerging, may be approaching more rapidly than planned, with due adjustments for country-specifics, as their arsenal of monetary measures gets exhausted and the limits of monetary policy are reached.

Inevitably, in such a situation, fiscal policy will have to get overextended and issues of medium-term sustainability of the fiscal stance will dominate the debate on global recovery. It is in this context that the authorities remain firmly committed to deepening and broadening the ambit of fiscal reforms, including efforts that secure lasting improvements in tax buoyancy, expenditure containment and targeting, and rule-based deficit management as embodied in the Fiscal Responsibility and Budget Management Act, 2003. It is important to note that the public debt has virtually no external component.

Market Sensitivity

22. In the final analysis, the staff's assessment of the outlook for the Indian economy appears to be driven by model-based scenarios of possible but unlikely catastrophic risks coming together. The robustness of the methodology is yet to be established. It is important to recognize that the staff appears alarmist, perhaps unjustifiably so. In the backdrop of heightened uncertainty in the global financial markets, when a confidence crisis could spread contagiously, such analysis emanating from the Fund could run the risk of triggering further financial instability. Therefore, a careful review may be required as to what portions of such analyses should be placed in the public domain. We also expect that such an analytical approach with appropriate and robust methodology will be applied evenhandedly across countries and regions.

Epilogue

23. The unprecedented crisis gripping the global economy warrants unconventional policy responses particularly in dealing with the "unknown unknowns" about the shape of things to come in the immediate future, most of which emanate from global uncertainty. This is a period of painful adjustment for all. Authorities across the world have been attempting to minimize its impact on the economy. Our authorities will continue to maintain vigil, monitor domestic and global developments and take swift and effective action to minimize the impact of the crisis and restore the economy to its potential growth path.