



# INDIA

## 2014 ARTICLE IV CONSULTATION

February 2014

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 2014 Article IV consultation with India, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 27, 2014, following discussions that ended on November 26, 2013, 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 9, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Staff Statement** of January 27, 2014 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its January 27, 2014 consideration of the staff report that concluded the Article IV consultation with India.
- A **Statement by the Executive Director** for India.

The following documents have been or will be separately released.

Selected Issues Paper

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

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# INDIA

## STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

January 9, 2014

### KEY ISSUES

**Context:** The tightening of global liquidity has increased external pressures and heightened the focus on India's macroeconomic imbalances (high inflation, large current account and fiscal deficits) and structural weaknesses (particularly supply bottlenecks in infrastructure, power and mining).

**Outlook and risks:** Growth is expected to slow to 4.6 percent this fiscal year, the lowest level in a decade, reflecting global developments and domestic supply constraints. Headline CPI inflation is expected to remain near double digits for the remainder of the fiscal year. The current account deficit is narrowing, driven by a significant improvement in exports, robust remittances flows, and a rapid diminution of gold imports. Nonetheless, India has very little room to adopt countercyclical policies, constrained by persistently-high inflation, and sizeable fiscal and external imbalances. Spillovers from renewed external pressures interacting with domestic vulnerabilities are the principal risks.

#### Key policy recommendations:

- High and persistent inflation is a key macroeconomic challenge facing India. Further increases in the policy rate will be necessary to tackle high inflation and inflation expectations.
- If external pressures from global financial market volatility resume, rupee flexibility should be the first line of defense, complimented by use of reserves, increases in short-term interest rates, actions on the fiscal front, and further easing of constraints on capital inflows.
- Further fiscal consolidation is needed. Tax and subsidy reforms will be required to durably lower fiscal imbalances.
- Enhanced financial sector supervision, better monitoring of banks' credit quality, and improved information on corporate vulnerabilities will be needed as a basis for tackling rising corporate and financial sector strains.
- Addressing supply bottlenecks and structural challenges—particularly in the agriculture and power sectors, and in the pricing and allocation of natural resources (including coal, natural gas, and fertilizers)—will be essential to achieve faster growth, job creation and poverty reduction.

Approved By  
**Nigel Chalk and**  
**Seán Nolan**

Discussions took place in Mumbai and Delhi during November 14–26, 2013. The staff comprised Paul Cashin (head), Rahul Anand, Volodymyr Tulin, Mehdi Raissi, (all APD), Peter Lindner (MCM), Ran Bi (SPR), and Tom Richardson (Senior Resident Representative). Nigel Chalk (APD) and Rakesh Mohan, Janak Raj and Muneesh Kapoor (all OED) also joined the discussions. The mission met with Reserve Bank of India Governor Raghuram Rajan, Economic Affairs Secretary Arvind Mayaram, Planning Commission Deputy Chairman Montek Singh Ahluwalia, other senior officials and representatives of the business community. May Inoue, Michael Dalesio, and Qianqian Zhang (all APD) assisted in the preparation of this report.

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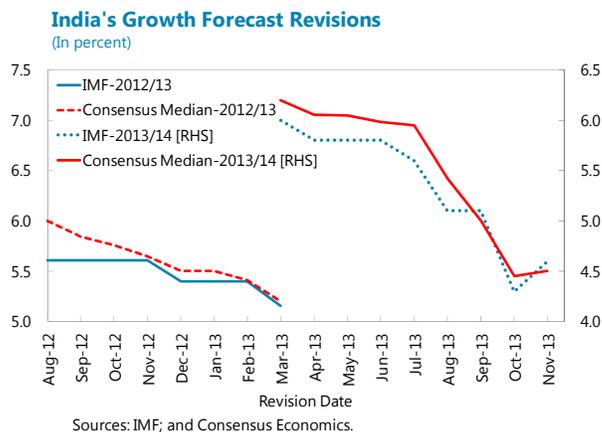
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## CONTEXT

**1. Growth has fallen sharply.** Growth averaged 8½ percent before and for two years after the global financial crisis but has decelerated throughout 2011 and 2012 (Figure 1), reaching 4.6 percent in FY2013:H1. Initially a problem of stalled infrastructure and corporate investment, the slowdown has become generalized across sectors. India's growth slowdown is unusual among emerging markets (EMs) both in its severity and the fact it has coincided with elevated inflation. Global factors have certainly hurt exports and weighed on investment. However, staff analysis indicates that about two-thirds of the slowdown can be explained by domestic factors, including supply bottlenecks, delayed project approval and implementation, and heightened policy uncertainty.



**2. Balance of payment pressures intensified during the summer of 2013 as external shocks interacted with domestic macroeconomic vulnerabilities.** As global liquidity conditions tightened, India was faced with significant portfolio debt outflows, and pressures on currency, equity, and bond markets. Investor concerns were amplified by India's persistently-high inflation, weakening growth prospects, large current account and fiscal deficits, and domestic political uncertainty (Figure 2). In response, liquidity conditions were tightened, limits on FDI and external borrowing were loosened, capital flow measures were introduced, and gold import duties were increased sharply (see Selected Issues Chapter I).

**3. Over the past four months, a combination of improving external conditions and domestic policy efforts have calmed markets.** Externally, global financial markets improved as the U.S. Fed decided not to advance the reduction in its monthly asset purchases. Domestically, the central bank increased its headline policy rate and intervened in FX markets by offering USD swaps to oil companies and to banks, with the latter leading to sizeable nonresident Indian (NRI) deposit inflows. In addition, the parliament passed the land acquisition, pension and companies bills, and thus far in 2013 the Cabinet Committee on Investment (CCI) has approved previously-stalled projects worth around 5 percent of GDP. On the fiscal front, measures were implemented to continue to raise diesel prices, to shrink the financial losses of state electricity boards, and to contain central government spending. As external pressures eased, the government was able to unwind the earlier steps taken to tighten liquidity and partly reverse restrictions on capital outflows (Annex I).

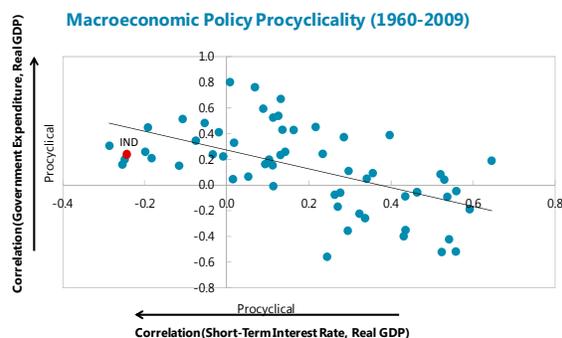
**4. Against the background of parliamentary elections (expected by May 2014) and prospective global liquidity tightening, policy discussions centered on mitigating risks associated with the challenging domestic and external economic environment.** Discussions focused on strengthening the macroeconomic position and containing vulnerabilities by narrowing fiscal and external imbalances to create space for countercyclical policies (see text chart), the

appropriate stance for monetary policy to decisively tackle high and persistent inflation, and the policy response to renewed global market volatility.

### 5. Past Fund advice and the authorities' macroeconomic policies have been broadly aligned, but progress on structural reforms has been slow.

Fiscal expenditure was lowered in 2012/13, consistent with Fund advice, and staff supports the authorities' intentions regarding the pace of medium-term

consolidation. The stance of monetary policy has been looser than staff recommended in 2012/13, but has been progressively tightened in 2013/14, consistent with Fund advice. Also, the central bank has allowed the currency to adjust flexibly to market conditions and intervened sparingly to counter excessive volatility in the exchange rate. Almost all key recommendations of the 2012 FSAP Update have been implemented (Annex II) and progress has been made in improving electricity pricing, and in achieving passage of the land acquisition, pension, and companies bills. Progress on product and labor market reforms has, however, been limited.



Source: Vegh and Vuletin (June 2012).

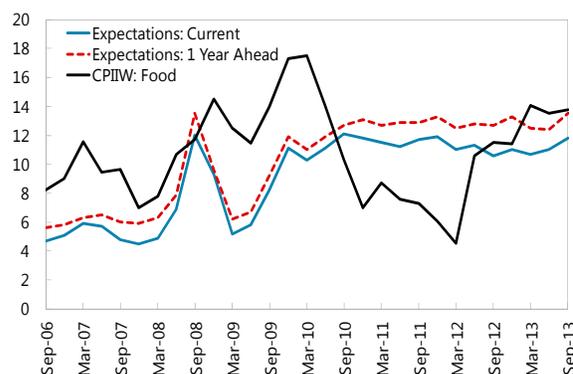
Notes: A positive (negative) Correlation (Government Expenditure, Real GDP) indicates pro-cyclical (counter-cyclical) fiscal policy. A positive (negative) Correlation (Short-Term Interest Rate, Real GDP) indicates counter-cyclical (pro-cyclical) monetary policy.

## OUTLOOK AND RISKS

### 6. The near-term outlook is characterized by relatively weak growth and high and persistent inflation.

Growth is projected at 4.6 percent this year and 5.4 percent in 2014/15 (at factor cost).<sup>1</sup> No further policy changes are assumed in the baseline, but slightly stronger global growth, improving export competitiveness, a favorable monsoon, and a confidence boost from recent policy actions should deliver a modest growth rebound in the near term. However, fiscal restraint and higher interest rates will act as headwinds, slowing the recovery. India's trend growth is currently estimated at around 5½ percent but is expected to rise to its medium-term growth potential of around 6¾ percent (under current policies) as unblocked investments are implemented and global growth improves. As a result of the weak economy the output gap has been widening, and is now estimated at about 1 percent of GDP.

**Household Inflation Expectations and Food Inflation**  
(In percent)



Sources: CEIC, Haver Analytics and IMF staff calculations.

<sup>1</sup> These correspond to 4.4 percent (2013) and 5.4 percent (2014) at market prices.

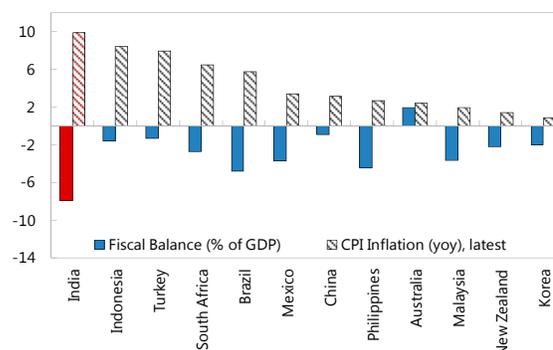
**7. Despite the growing output gap, monthly CPI inflation (yoy) is expected to remain near double-digits well into next year.** The high headline inflation is a result of a number of factors, including: food inflation feeding quickly into wages and core inflation; entrenched inflation expectations; cost-push shocks from binding sector-specific supply constraints (particularly in agriculture, energy, and transportation); the pass through from a weaker rupee; and ongoing energy price increases. WPI inflation is expected to rise to 7.4 percent by March 2014, remaining well above the RBI's comfort zone and falling only slowly (to 6.3 percent by March 2015).

**8. The current account deficit is narrowing fast.** The current account deficit reached a record 4.8 percent of GDP in 2012/13 due to sharply weaker exports, higher imports of oil and gold, and binding supply constraints (particularly in coal and iron ore). India's external vulnerabilities have fallen significantly in recent months, helped by policy actions taken to shrink the current account and strengthen capital flows. In particular, the current account deficit has been on a marked downward trajectory as exports improved, remittance inflows remained solid, and higher import duties and quantitative restrictions discouraged gold imports.<sup>2</sup> In addition, non-oil, non-gold imports have declined in line with weak domestic demand, and capital inflows have strengthened.

**9. Staff expect the current account deficit to fall to around US\$61 billion (3.3 percent of GDP) in 2013/14.** The current account deficit is expected to continue declining over the medium-term as domestic mining constraints ease, external demand improves, and the competitiveness-enhancing effects of depreciation are fully realized. This smaller deficit is expected to be financed by a combination of FDI and an increased reliance on debt, including inflows of deposits from non-resident Indians. There are, however, risks that the current account deficit could be higher depending on: (i) the ability to successfully lower CPI inflation (which will be essential to generate the sustained reduction in gold imports and increase in households financial savings that is assumed in the forecasts); (ii) the potential for higher oil prices; and (iii) the pace of recovery of external demand. India's gross international reserves are comfortable (at US\$296 billion at end-December 2013, or 145 percent of the Fund's reserve adequacy metric) and are expected to rise steadily to US\$314 billion by March 2015 (Figure 3).

**10. The principal risk facing India is the inward spillover from a tightening of global liquidity interacting with domestic vulnerabilities** (Annex III). International reserves are ample, but recent experience highlights that, with U.S. monetary policy normalizing, the impact from global financial market volatility could be disruptive (Figure 4). With a still-significant external financing need, India is

**CPI Inflation and Fiscal Balance, 2012**  
(in percent)



<sup>2</sup> However, the limits on gold imports should be viewed only as a stop-gap measure and have the potential to become less effective over time (including from increased smuggling). Durably lowering the demand for gold as a store of value will only be achieved through low inflation, raising real interest rates on deposits, and ensuring macroeconomic stability.

exposed to higher global interest rates and a reversal of capital flows. Such pressures could tighten domestic financial conditions, weaken corporate and bank balance sheets, curtail credit growth, and force a further procyclical tightening of monetary and fiscal policy. This could further raise borrowing costs, trigger portfolio outflows, and create the potential for disorderly adjustments in exchange rate and asset prices. Potential upsides to the outlook would arise from healthier global growth or lower oil prices.

**11. On the domestic front, risks stem from slow progress in addressing infrastructure and supply-side constraints (particularly in the power and transportation sectors).** Unless binding supply constraints are decisively addressed, high inflation and slow growth will continue to undermine macroeconomic and financial stability, necessitating a tighter monetary policy stance (Box 1). Given the commitment to medium-term fiscal consolidation, fiscal policy will not be able to provide support to domestic demand, which will also weigh on growth. On the other hand, growth upsides could arise from further investor-confidence-boosting policy actions (for example, if diesel price increases were accelerated), a greater-than-expected response of exports to the weaker currency, or faster implementation of CCI-approved projects. Outward spillovers from an output shock in India would have modest global implications (given the scale of India's trade and financial flows), but would affect some neighboring countries in South Asia through trade, remittances and FDI channels (see Selected Issues Chapter II).

### Authorities' Views

**12. The authorities were more sanguine than staff about India's near-term growth prospects.** Citing green shoots in the data for power generation and exports, good agricultural performance and robust rural demand, they consider a growth projection of 5 percent to be reasonable for FY13/14, rising to 8 percent in 2–3 years. Order books are filling up, iron ore projects have been unlocked, and thus far in 2013 the CCI has cleared projects worth US\$95 billion, which should translate into a pickup in activity in the final months of FY 2013/14. The authorities noted that final GDP data, using the broader-based Annual Survey of Industries, would be higher than the preliminary, industrial production-based quarterly GDP figures. They were also of the view that fiscal expenditure restraint would not have a material effect on near-term growth.

**13. The authorities agreed that a sharp adverse swing in market sentiment prompted by a scaling back of unconventional monetary policies (UMP) in advanced economies is the main risk currently facing India.** They pointed to the need for greater clarity and communication by policy-makers in advanced economies in regard to the planned pace of UMP tapering. At the same time, they considered that India's domestic fundamentals were strong (reflected in the oversubscription of the IFC's first off-shore issuance of rupee-linked bonds), and that vulnerabilities had been addressed, particularly on the external side. The authorities stated that the recent decline in gold imports can be sustained, given the introduction of inflation-indexed bonds—offering households an alternative inflation hedge to gold—and further stabilization of the macroeconomic situation. They agreed with staff that exchange rate flexibility is an important policy feature that helps to contain external risks, and considered the RBI's stock of international reserves to be broadly adequate to address any need to smooth short-term volatility.

**14. The authorities noted that India has demonstrated its ability to respond to shocks and market concerns.** While recognizing that more chronic problems—such as persistent inflation—have been allowed to linger, the authorities argued that vigorous policy responses had been forthcoming when actions were urgently needed. For example, when the fiscal deficit became a matter of concern in FY 2012/13, the Ministry of Finance delivered on restraining spending to meet the deficit target. Similarly, when markets feared the current account deficit was becoming excessive, the government put in place effective measures to rein it in and to mobilize over \$34 billion in net capital inflows (largely through NRI deposits).<sup>3</sup>

## POLICY PRIORITIES

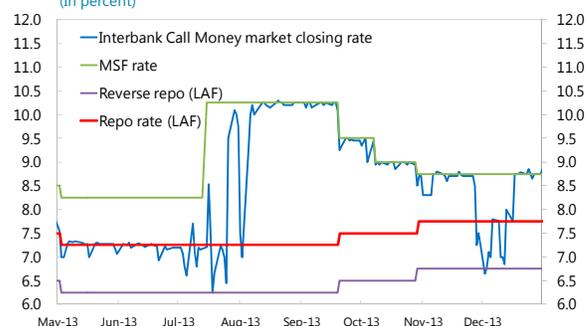
*India has very little space for countercyclical policy stimulus. Monetary policy will need to be tightened to durably reduce inflation, and high budget deficits afford little scope for fiscal support to the economy. As a result, expediting structural reforms is the only feasible option to boost both actual and potential growth, create jobs to absorb India's rapidly-growing labor force, and reduce poverty.*

### A. Monetary Policy

**15. In the summer, in the midst of exchange market pressures, the RBI took a number of steps to tighten domestic liquidity and support the exchange rate** (Annex IV). India's monetary policy response relied on a tightening of money market liquidity engineered by:

- Limiting the provision of liquidity under the Liquidity Adjustment Facility (LAF) to 0.5 percent of bank's own net demand and time deposit liabilities (NTDL).<sup>4</sup>
- Increasing the Marginal Standing Facility (MSF) interest rate by 200 bps to 10.25 percent, thereby increasing the wedge between the interest rates on the LAF and the MSF from 100 to 300 basis points.<sup>5</sup>

**Policy and Call Market Interest Rates**  
(In percent)



Sources: RBI and IMF staff calculations.

<sup>3</sup> The RBI introduced two foreign exchange swap schemes in September 2013—one to encourage new foreign exchange deposits into India by non-resident Indians with a minimum term of three years; and one to encourage long-term overseas foreign exchange borrowing by banks. Under both swap schemes, the RBI agreed to sell to banks on a forward basis and until November 30, 2013, USD against rupees at concessional rates, which gives rise to multiple currency practices (MCP) relating solely to capital transactions. These MCPs are not subject to Fund approval because the Fund has declined to assert jurisdiction over MCPs relating solely to capital transactions (see BUFF/85/34).

<sup>4</sup> The initial recalibration of the LAF on July 15 specified an overall limit of 1 percent of NTDL of the banking system. LAF is a key element of the operating framework of the RBI.

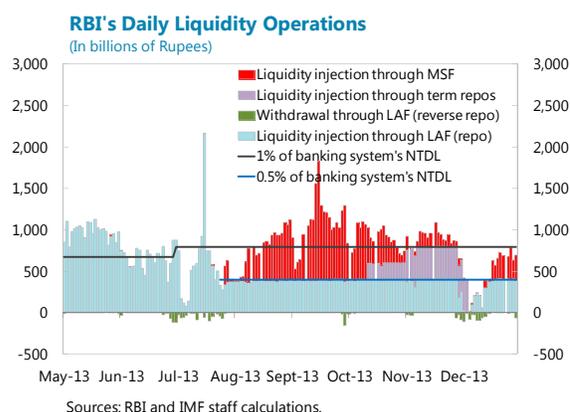
<sup>5</sup> The MSF allows banks to borrow overnight at their discretion up to two percent of the respective NTDLs, at a margin above the repo rate, against collateral of government securities.

- Tightening the averaging rules for the cash reserve ratio (CRR) by requiring banks to meet at least 99 percent of CRR on daily basis (up from 70 percent earlier).
- Undertaking open market sales of Government of India Securities by the RBI (of around INR 150 billion during July-August 2013).

As a result, the interbank call money market rate was increased by some 300 basis points with the MSF rate becoming the effective policy rate, money market and three-month t-bill rates rose by about 300 basis points, and there were lesser increases in rates further out the yield curve. The preference for these liquidity-tightening measures to increase short-term interest rates (rather than increase the policy rate) was due to the fact they could be put in place quickly and be easily unwound as pressures eased. In addition, these measures were more targeted at supporting the rupee by significantly raising the short-term costs of shorting the currency. A comparable tightening (of 300 bps) undertaken through increases in the repo rate would have been unprecedented, likely had a larger impact on growth, and been politically difficult to achieve.

#### 16. As external pressures have abated, the RBI has moved to normalize monetary policy.

Since September, the RBI has gradually unwound the liquidity measures by lowering both the MSF rate (by 150 bps) and daily CRR requirement (to 95 percent) and expanding access to term repos. At the same time, the repo rate was increased by 50 bps (to 7.75 percent), restoring the interest rate corridor to the 100 bps that existed prior to mid-July. As pressures on the currency have eased and markets have normalized, the RBI's strategy to restore the repo rate as its primary policy instrument has been fully appropriate.



**17. However, inflation remains too high and the RBI will need to continue raising policy rates in the coming months.** High and persistent inflation is a key vulnerability that has caused household inflation expectations to continuously exceed actual inflation and become embedded in behaviors. This, in turn, has driven a rising demand for gold and is adding to downward pressures on the rupee. The RBI's resolve to pay greater attention to headline CPI in monetary policy formulation and to strengthen its anti-inflationary efforts are commendable. However, the ingrained nature of inflation and inflation expectations mean that reducing inflation—even over a protracted horizon—will require significant increases in policy rates, which will weigh on growth.<sup>6</sup> Given uncertainties surrounding the strength and lags associated with the monetary transmission mechanism, an incremental approach to monetary tightening is warranted. However, it will be important to

<sup>6</sup> As an illustrative guide of the adjustment required, calculations using a Taylor rule (embedded in a structural forecasting and policy model customized to India's specific circumstances) suggest that the repo rate would need to rise significantly over the next six months from its end-November level of 7.75 percent, in order to lower inflation expectations, tackle inflation inertia, and sustainably lower CPI inflation to around 7 percent by end-2015 (see Selected Issues Chapter III).

communicate the RBI's policy reaction function and the shift in its tolerance for high CPI inflation through clear forward guidance on the direction and intent of policy. In addition, should high inflation expectations persist and inflation remain sticky, a more front-loaded path of interest rate increases may be needed (Figure 5).

**18. Sustainably lowering inflation will require a simpler monetary framework with clear objectives and operational autonomy for the RBI:**

- The RBI should move towards adopting the containment of inflation as its primary objective, with headline CPI inflation providing the principal nominal anchor for monetary policy.<sup>7</sup> The evolution of the CPI plays a key role in influencing both inflation expectations and wage formation.<sup>8</sup> While the RBI should see through the impact of transitory shocks, the current evolution of food prices, rising at a rapid pace for several years, is not a transitory phenomenon and reflects both consumption demand and supply constraints. In addition, empirically, food price shocks propagate strongly and rapidly into non-food, non-fuel (core) prices.
- To further enhance the effectiveness of monetary policy, the RBI should clearly communicate how it intends to meet its stated inflation objectives and, as part of that process, should publish rolling one-year-ahead projections of both the CPI and WPI.
- In terms of monetary operations, the overnight repo rate should remain the principal policy tool, deployed in the context of a fully flexible exchange rate.
- In the context of implementation of the Financial Sector Legislative Reform Commission's (FSLRC) recommendations (Box 2), legislative changes should be made to underpin the RBI's operational autonomy.

**Authorities' Views**

**19. The authorities agreed that inflation was too high, and that monetary policy would need to remain vigilant over the near term.** At the same time, they noted that supply-driven, food inflation is a key driver of the headline number. With the good monsoon this year, they believed food inflation should fall and that, in any case, monetary policy has a limited role in tackling food inflation. The authorities agreed that the output gap remains significantly negative and should help lower inflation going forward. As a result, they consider that the growth – inflation tradeoff will need to be carefully managed and there was a significant risk of overtightening, particularly in light of the need to create jobs to absorb India's growing labor force.<sup>9</sup> The central bank noted that, given the

<sup>7</sup> The RBI has had both an immediate inflation objective (WPI inflation should lie within a range of 4–4½ percent) and a long-term inflation objective (WPI inflation at 3 percent). The weight attached to these objectives is unclear, since WPI inflation has exceeded the target range for the past three years and is projected by the RBI to remain at around 6½ percent in the near-term.

<sup>8</sup> A narrower focus, for example on core CPI, would not be appropriate. See R. Anand, D. Ding and V. Tulin (2013), "Assessing Second-Round Effects of Commodity-Price Shocks in India", IMF WP (forthcoming) for a discussion.

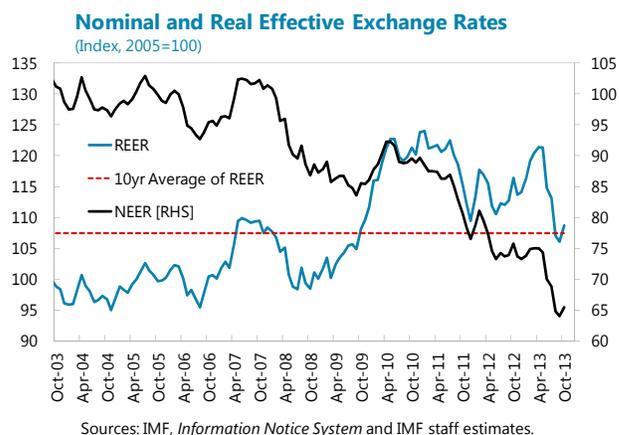
<sup>9</sup> As such, at its December 2013 policy meeting, the RBI opted to leave rates on hold, providing time to examine incoming data on the trajectory for inflation.

risks of derailing the ongoing economic recovery and uncertainties surrounding monetary transmission, a gradualist approach was needed to disinflate the economy over an extended period. They were less persuaded of the need for a further, significant increase in policy rates to lower inflation and inflationary expectations. Instead, they believed it would be prudent to give some time for the effects of the recent interest rate increases to feed through before revising the policy stance.

**20. The authorities indicated they would take a view on possible changes to the monetary policy framework only after the Patel Committee issues its report** (expected in early 2014). They emphasize that they have been working, through their communications strategy, to shift the dialog with markets toward the CPI, which they consider will enhance the RBI's credibility on inflation issues over the medium term. They are not persuaded of the need to release rolling, year ahead forecasts of inflation, but they made it clear that significant internal and public conversations are still to be had before the authorities settle on any change in the basic monetary policy set-up.

## B. Addressing External Vulnerabilities

**21. Recent experience has shown that exchange rate flexibility is an essential tool in coping with volatile capital flows.** The flexible rupee has been an important shock absorber and should continue to play that role. The RBI has ample reserves and, if needed, is able to provide foreign currency liquidity, through both swaps and spot intervention, to prevent disruptive movements in the exchange rate and check any self-fulfilling momentum that is divorced from exchange rate fundamentals. Based on a range of empirical methodologies, the FY 2013/14-average real effective exchange rate appears to be slightly over-valued (Annex V).<sup>10</sup> As such, and given the sizable inflation differential with trading partners, some further modest nominal depreciation from current levels should not be a cause for concern.



**22. Recent policy measures have been targeted at improving the environment for capital inflows.** India has shifted from a pre-Lehman Brothers era where FDI flows more-than-financed the CAD, to a situation where FDI covered only around one quarter of the deficit in 2012/13, with a corresponding increased reliance on debt flows. Over the past year the authorities have taken multiple steps to bolster capital inflows, including liberalizing the caps on FDI inflows; relaxing

<sup>10</sup> Based on the External Balance Assessment, the May 2013 External Sector Report concluded that India's cyclically-adjusted current account and the value of the rupee are broadly in line with fundamentals, with the EBA current account regression approach indicating that the current account deficit was smaller than a level compatible with fundamentals and desired policies. Since the release of the External Sector Report, subsequent calculations by Fund staff suggest that the medium-term current account norm for India is a deficit which is centered around 2½ percent of GDP, a level slightly smaller than the forecasted medium-term current account (see Annex V).

restrictions on external commercial borrowing; offering FX swaps to banks to attract more NRI deposits and increase banks' ability to borrow; and working with the IFC in its US\$1 billion bond program directed at offshore investors. The authorities have also supported the currency by providing dollars directly to oil importers through FX swaps (see Annex IV for details of FX swaps to banks and oil importers and their impact).<sup>11</sup> In addition, a swap line with the Ministry of Finance Japan has been increased from \$15 billion to \$50 billion, and the government is considering increasing imports of cheaper Iranian oil, which can be partly settled in rupees.

**23. Further opening up of the capital account should, however, be undertaken prudently.**

The opening to FDI and portfolio flows which occurred in 2013 will help finance the current account deficit. However, given the potential risks to corporate balance sheets, a further relaxation of external commercial borrowing (ECB) rules should be undertaken only incrementally and cautiously alongside a deeper domestic financial market. Options of issuing a maiden international sovereign bond, if market conditions permit, and of seeking entry into global bond indices, should be explored. The authorities could also look into increasing the availability of bilateral swap lines. The flexible rupee and recent movements in the currency have increased incentives to hedge FX exposures. As such, the relaxation of restrictions that reduce the depth of the onshore forwards and futures markets would be beneficial.<sup>12</sup>

**24. If external pressures re-emerge, a well-communicated package of policy measures should be put in place to minimize disruptive movements in the currency and bolster confidence.**

Going forward, an improving export environment, an easing of supply bottlenecks to shrink import demand, and a smaller fiscal deficit should help reduce external vulnerabilities. Nevertheless, if capital account pressures were to resurface, continuing to allow the rupee to adjust flexibly to market conditions will be essential. In addition, a comprehensive plan should be announced to:

- Tighten monetary conditions through both an increase in the repo rate and a renewal of liquidity tightening measures to make it more costly to short the rupee. Such measures would help contain the inflationary impact of exchange rate depreciation and, temporarily, bolster the capital account position. However, liquidity tightening should be seen as a complement to, not an expedient substitute for, raising the repo rate. In following this approach, it will be essential to clearly communicate the central bank's intentions and its motivations for using the range of tools it has in its monetary toolkit.

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<sup>11</sup> The magnitude of the FX swaps is fully disclosed through the Special Data Dissemination Standard (SDDS) template on both the RBI and IMF websites.

<sup>12</sup> Key restrictions include: banks have been banned from proprietary trading in domestic currency futures and exchange traded options; margin requirements on domestic U.S. dollar-rupee forward trades were doubled to 100 percent; and FIIs and NRIs cannot trade currency futures in India.

- Deploy India's ample FX reserves, including by again taking oil marketing companies out of the spot market and offering them a short-term bilateral FX swap window priced at market rates. Recent experience indicates that this has been an effective strategy in changing market expectations and, as such, should be used again.
- Similarly, FX swaps for NRI deposits (at market-based rates and without the subsidy embedded in the recent NRI swaps) should again be offered if needed.
- A clear package of fiscal measures, in addition to those needed to achieve fiscal targets, would help support confidence and lessen the burden on the central bank in reacting to market pressures. These could include administrative action to raise diesel prices at a faster pace, and further limit the subsidized consumption of LPG.
- Measures to further restrict capital outflows should be avoided, not least because recent experience suggests that they could well be counterproductive, potentially catalyzing capital flight through different routes. The renunciation of such measures should be clearly communicated to bolster investor confidence.

The mission noted that it would be important for the government to develop an agreed set of contingency plans—along the lines described above—so as to be ready to react to heightened market pressures. These plans should be fully coordinated across the relevant government agencies and would constitute a highly valuable preparatory exercise.

### Authorities' Views

**25. The authorities argued that external vulnerabilities have been greatly reduced, owing in large part to strong policy actions taken.** Gold imports have been sharply curtailed, and goods and services exports are starting to pick up even before the full impact of rupee depreciation is felt. FII debt inflows have been negative since May but equity investment flows have remained resilient. With only a relatively small amount of FII debt remaining, the mix of FII money now present on Indian markets has become more durable. The authorities noted the effectiveness of the FX-swap scheme for oil marketing companies in stabilizing the currency market and shifting market sentiment. They also pointed to the success of their efforts to mobilize durable capital inflows, particularly from NRIs and FDI.

**26. The authorities agreed that exchange rate flexibility would continue to be a key pillar of their response to external volatility.** In their view, the broad thrust of the liquidity tightening and FX intervention policies employed during July-September had been correct. They argued that with the Reserve Bank of India moving towards improved communication of its views, the risk of volatility would be further reduced. Looking ahead, if faced with a similar round of capital flow volatility, they indicated that the thrust of their response would likely be similar, using a combination of exchange rate flexibility, some monetary tightening, and, if needed, limited use of foreign exchange reserves.

**27. The authorities indicated that a new crisis management framework has been established under the management of the inter-regulatory Financial Stability and Development Council (FSDC).** The authorities argued that this group, which has met regularly over the past few months, should enhance India's ability to respond to shocks threatening the Indian financial system. At the same time, they recognized this was a work-in-progress and agreed with staff's suggestion to test the FSDC crisis management system, potentially in a "war game exercise" setting.

### C. Fiscal Policy

**28. There is a firm commitment to meet the 2013/14 fiscal deficit target, but achieving this goal will be challenging.** The authorities demonstrated their commitment to fiscal consolidation by meeting the Budget deficit target for 2012/13, despite a slowing economy (Figure 6). Politically difficult steps were taken to raise fuel and retail electricity prices, target direct cash transfers using the expanding Unique Identification (UID) program (Box 3), and restructure the debt of public electricity distribution companies. For 2013/14, the Budget deficit target of 4.8 percent of GDP appears achievable.<sup>13</sup> However, weak revenue growth, higher global oil prices, rupee depreciation, and higher interest rates, mean that achieving this near-term goal will entail significant reductions in spending. For this fiscal year, in addition to the announced measures to rationalize non-plan expenditure, the target is expected to be met by requiring agencies to give up un-utilized spending allocations, and to not release further budgeted amounts to such agencies. In addition, cash-rich public sector enterprises are being asked to transfer higher dividends to the central government. Such efforts, however, will create a substantial additional drag on growth, particularly given that fiscal multipliers on such spending are relatively large in India.<sup>14</sup> Additional fiscal reforms (including better-targeted subsidies, introduction of a GST and direct tax code) are unlikely to be introduced before the May 2014 general elections, although there is some discussion of raising diesel prices at a somewhat faster pace in the remainder of this fiscal year.

**29. The government's goal of a 3 percent of GDP deficit target by 2016/17 represents a reasonable medium-term consolidation plan, but the policies to achieve that outcome have yet to be articulated.**<sup>15</sup> A better quality of fiscal adjustment could be achieved through a more balanced package of revenue measures and expenditure reductions. In particular, the staff would recommend the following package of fiscal reforms to meet the authorities' medium-term fiscal target:

- *Approving the goods and services tax.* This represents the single most important revenue reform and will help boost growth by lessening distortions and creating a single Indian market for goods and services.

<sup>13</sup> This implies a deficit of 5.3 percent of GDP under the IMF's definition, due to the differential treatment of disinvestment proceeds.

<sup>14</sup> See J. Tapsoba (2013), "Options and Strategies for Fiscal Consolidation in India," IMF WP 13/127.

<sup>15</sup> Staff's medium-term fiscal forecasts are calculated on the basis of current policies and, as such, show relatively little fiscal adjustment in the coming years.

- *Approving a new direct tax code* with streamlined and smaller deductions, *raising excise taxes* back to pre-GFC levels, and *improving tax administration*.
- *Reforming untargeted subsidies on fuel and fertilizer*. Continuing the ongoing move toward targeted transfers will have strong beneficial effects on growth and the distribution of income. This should be the central plank of expenditure rationalization and will allow spending to be redirected toward more socially- and economically-productive areas (including greater investment in health and education). An important step would be to raise diesel prices at a more accelerated pace, so as to ensure full cost recovery by mid-2014 (and thereafter link domestic fuel prices to movements in international prices).
- *Targeting food subsidies*. The recently-passed Food Security Act—which aims to provide subsidized rice, wheat and coarse cereals to 67 percent of the population—is expected to add significantly to the fiscal subsidy burden going forward (Box 4). Efforts should be made to convert these subsidies to a system of targeted, direct cash transfers as quickly as possible. In addition, governance and transparency in the allocation of subsidized food should be strengthened and the efficiency of the Public Distribution System enhanced.
- Adhering to the *Fiscal Responsibility and Budget Management Act (2003)* by the central government. This would imply that the central government commits and adheres to a credible path of fiscal consolidation, reaching a central government deficit of 3 percent of GDP by FY 2016/17.
- *Minimizing additional pressures on the fiscal position* from future bank recapitalization needs (including by increased bank provisioning) and the liabilities of electricity distribution companies (by continuing to raise tariffs to cost recovery levels).

Focusing on the implementation of a more sustainable package of fiscal reforms, as described above, would build confidence, support monetary policy in fighting inflation, free resources for investment, lessen vulnerabilities and generate a positive dynamic of lower financing costs and improved economic and social prospects. Without such measures, the composition of fiscal adjustment will likely be met through a compression in needed capital spending or an underfunding of important social programs, which would undermine growth and the government's laudable pro-poor and inclusive growth goals (see Selected Issues Chapter IV).

**30. Even without medium-term fiscal adjustment, government debt remains on a sustainable trajectory, and is projected to stabilize at around 64 percent of GDP in 2017/18.**

The public debt sustainability analysis (DSA) using the Fund's new DSA template suggests that India's public debt burden remains manageable. While the baseline scenario already uses conservative real GDP growth assumptions, further negative growth shocks represent one of the major risks to the debt outlook, with shocks to real interest rates and contingent liabilities posing additional risks (see Annex VI).

## Authorities' Views

**31. The government has reiterated the importance of meeting its FY13/14 Budget deficit target.** The authorities stated that this was a “redline” with strong credibility implications if not met. As such, no slippage will be permitted. They argued that revenue performance this year is on track, and they emphasized that meeting the deficit target does not entail an expenditure cut, but only involves expenditure rationalization by recalling unspent balances with spending units and not releasing further budgeted amounts to them. Fiscal accounting in India is done on a cash, not accrual basis, so the authorities recognize the risk that some spending pressure from this year could spill into next year. However, they point to the fact that similar spillovers happen every year, and they argue that there is no evidence that the size of this carryover is growing from year to year.

**32. The authorities agreed that fiscal consolidation was needed over the medium term.** In their eyes, the goal of reducing the central government deficit to 3 percent of GDP (authorities' definition) by 2016/17 is achievable, but they did not believe there was a need to re-invigorate the Fiscal Responsibility and Budget Management (FRBM) process. The FRBM Act has recently been amended to adopt this target, therefore, revising the Act at this stage may not be needed. Revenue enhancement is key, particularly through better tax administration, and the authorities were hopeful that the goods and services tax (GST) and the direct tax code (DTC) bills will be passed by next year. The authorities are also optimistic that direct cash transfers—combined with the unique identification (Aadhaar) system—will generate significant fiscal savings through de-duplication of subsidy recipient rolls. The authorities do not see significant risks to fiscal consolidation from implementation of the Food Security Act, and underlined the importance of the Act in tackling poverty and hunger and ensuring improved social outcomes.

## D. Financial and Corporate Sector Issues

**33. Strains are building as corporate financial positions deteriorate and bank asset quality weakens** (Figure 7). Slowing growth, the delayed authorization of permits for infrastructure projects, and rising costs of capital are placing pressure on corporate profitability. Average corporate leverage and debt payment capacity are not markedly worse than during the global financial crisis, but default probabilities of the most vulnerable 10 percent of firms are far greater than in 2009. This vulnerability is further aggravated by concentration risk: banking sector loans to India's ten largest conglomerates account for almost 100 percent of banks' net worth.<sup>16</sup> The banking system is well capitalized (the capital adequacy ratio was 13.8 percent in March 2013), but nonperforming assets (4.2 percent of total advances) and restructured loans (an additional 5.7 percent of gross advances) are expected to continue to rise. The deterioration in credit quality has been worse among public banks where lending is concentrated in poorer-performing sectors such as infrastructure (especially power), aviation, agriculture, steel, and textiles. However, despite the sizeable recent depreciation in the exchange rate, there has, as yet, been little apparent additional strain on corporate balance sheets arising from currency mismatches (see Selected Issues Chapter V). In addition, new capital injections

<sup>16</sup> See Credit Suisse (2013), “House of Debt Revisited,” Credit Suisse Securities Research.

for India's banks (to meet Basle III requirements and additional capital requirements due to restructured loans being reclassified as NPAs) are likely to be manageable (Box 5).

**34. Enhanced financial sector supervision and monitoring, and increased bank provisioning, are warranted.** To tackle rising strains in the financial system, and improve the functioning of financial intermediation more broadly, the RBI has outlined its plans to further enhance the monitoring and supervision of banks' credit quality and require banks to further increase provisioning. In particular, the RBI's recently-introduced incremental provisioning and capital requirements for bank lending to corporates with foreign-currency exposures are steps in the right direction. As recommended in the FSAP, advances and commitments to interrelated companies should be appropriately measured and limited, and the existing ceilings fully enforced—this is a critical measure and should be undertaken prior to issuing new banking licenses (see Annex II). A further priority should be to gather information on, and analyze, the inter-linkages between corporate vulnerabilities and the health of the banking system, particularly on the extent of unhedged FX exposures of large firms with international operations.

**35. Strengthening prudential regulation for banks' asset quality classification and concentration risks are needed.** Implementation of the Mahapatra Committee's recommendations (to more rigorously classify restructured advances) is a step in the right direction, but further measures in the areas of asset quality recognition and concentration risks are needed. The objective should be to fully recognize the true asset quality of banks' portfolios, with restructured loans counted toward nonperforming assets immediately after a restructuring, and then moved to the performing bucket only after a period of satisfactory performance. This is of particular importance for the public sector banks. Moreover, all sectors of the economy (including infrastructure and real estate) should be subject to the same loan quality classification rules.<sup>17</sup>

**36. Enhancing the institutional and legal framework for debt recovery is an important step.** This will require improvements in the legal and institutional insolvency framework, the regime for insolvency professionals, the functioning of the distressed asset market, and out-of-court settlement procedures. Initial steps by the FSLRC to explore updating India's financial regulatory architecture should be intensified, to bring the institutional and legal framework in line with India's fast-growing and complex financial system.

**37. Various financial sector reforms should increase credit availability and broaden access to financial services.** Recently-announced plans to simplify bank branch licensing, create inclusiveness criteria for underserved areas, and enhance competition in the banking sector—including by accelerating the approval process for new private sector banks and opening the Indian market further to foreign banks—will expand access. The December 2013 introduction of CPI-indexed bonds (particularly those sold to retail clients) is a further positive step and will help reduce

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<sup>17</sup> The banking sector is subject to a number of additional regulatory requirements, many of which are distortionary in nature. These issues have been covered in the 2012 Financial Sector Stability Assessment Update (IMF Country Report No. 13/8).

the demand for gold and divert savings to productive uses, intermediated by the domestic financial system. Other welcome reforms already underway include: introduction of a ten-year bond futures contract; improvement in the recovery mechanism for distressed debt; and establishing the central large borrowers' database, which will improve the supervision of large exposures. In addition to these efforts, gradually reducing the Statutory Liquidity Requirement, concomitant with a decline in the fiscal deficit, will help free up resources for lending to the private sector rather than channeling savings into government securities. On the financial inclusion side, the Governor's call for a feasibility study on mobile banking offers the possibility to integrate currently un-banked segments of India's population into the financial system.

### Authorities' Views

**38. The authorities recognize that corporate profitability has fallen, putting pressure on financial sector balance sheets.** They agreed with staff that these pressures, while manageable at present, will need to be carefully monitored going forward, and noted that other major EMs are facing similar strains. The RBI is keen to find ways to incentivize the early recognition of problem assets by banks, and the authorities feel that the newly-adopted Companies Act should over time facilitate a clearer insolvency framework. The authorities also acknowledge that the foreign exchange exposure of Indian corporates is not fully clear, but they believe that most such borrowing has either a formal or natural hedge.

**39. The authorities emphasized the potential impact of a range of reforms to strengthen financial intermediation and advance financial inclusion.** In particular, the RBI laid out the five pillars of its planned developmental measures to improve the Indian financial system. These include: (i) strengthening the monetary policy framework; (ii) enhancing banking structure (through new bank entry, branch expansion, encouraging new varieties of banks); (iii) broadening financial markets (by improving the liquidity and depth of government securities, money, derivatives, and corporate debt markets); (iv) expanding financial inclusion (involving better access to finance for SMEs, the underserved parts of the population, through technology (such as mobile banking) and business practices (for example, maintaining the requirement that banks open at least 25 percent of their branches in unbanked rural centers); and (v) improving the financial system's ability to handle corporate and financial institution distress (by strengthening financial restructuring, procedures for rescue of viable businesses, and insolvency practices).

## E. Structural Policies to Boost Growth

**40. Key structural reforms are needed to reduce supply bottlenecks, bolster employment growth, improve medium-term growth prospects, enhance growth inclusiveness, and reduce poverty.** While major policy actions may understandably be difficult to implement ahead of the general elections expected by May 2014, any positive steps taken would enhance investment, improve the supply response of the economy, and help raise potential growth.

**41. Nonetheless, slow action on key structural reforms** (introduction of GST, comprehensive energy and fertilizer subsidy reforms, agricultural reforms, and power sector reforms) continues to

adversely affect sentiment and domestic investment (see Selected Issues Chapter VI). Needed inclusive growth-promoting measures include:

- *Addressing structural challenges in the power sector and in natural resources.* State Electricity Boards (SEBs) have raised tariffs but much more needs to be done to eliminate losses. The pricing and allocation of a wide range of natural resources (including coal, natural gas, electricity, and fertilizers) are subject to complex and cumbersome mechanisms and regulations, which need to be addressed. Moving the pricing and allocation of natural resources toward a market basis would make them more transparent and raise investment.
- *Easing strict labor regulations and addressing skills mismatches.* These will be vital to raise productivity, increase formal sector employment, and improve potential growth. Raising educational attainments and enhanced focus on vocational training are required to ease India's skill mismatch (see also Selected Issues Chapter VII).
- *Reforming the agriculture sector,* particularly reducing administrative inefficiencies in food distribution, pricing, and storage, and boosting productivity in agricultural production.
- *Enhancing health and education outcomes* by sustainably increasing spending, improving their quality, raising the efficiency of social programs and focusing on inclusiveness (as emphasized in the 12th Five-Year Plan).
- *Strengthening the business, trade, and investment climate and enhancing governance.* According to a range of business environment indicators, India underperforms in areas necessary to run a business (e.g. trading across borders, enforcing contracts, and resolving insolvency) but performs better in the areas of obtaining credit and protecting investors (Figure 8).

### Authorities' Views

**42. There is consensus that structural reforms are going to be the lynchpin of an eventual rebound in growth.** The authorities note that a number of long-awaited legislative measures have been passed recently, and that the Cabinet Committee on Investment is now seeing success in unlocking key infrastructure projects. Power linkages are well-understood as a bottleneck, and more effective health and education spending will be key to ensuring that the "demographic dividend" pays off. At the same time, there is not the same level of consensus on the need for labor market reform, and the authorities do not agree with India's ranking on the World Bank's ease of doing business indicators, questioning the methodology used in arriving at these rankings. They pointed instead to the recent Ernst and Young *Global Confidence Barometer* (issued October 2013), which ranked India among the most favored of global investment destinations.

## STAFF APPRAISAL

**43. India presently faces a challenging macroeconomic landscape.** A weakening risk appetite toward major emerging market economies, along with global liquidity tightening, have placed pressure on India's balance of payments. However, there is little room for countercyclical macroeconomic policies to respond. Rather, a tightening of fiscal and monetary policies is needed to

narrow macroeconomic imbalances, supported by actions to relieve supply-side bottlenecks. The key near-term risk arises from a sudden stop in external capital inflows, emanating from either domestic or external triggers.

**44. The immediate outlook is for a gradual growth recovery and persistently-high inflation.** Growth will reach its nadir in 2013 on weaker domestic investment and tepid external demand. India's growth has underperformed in recent years, largely due to domestic factors (chief among them policy uncertainty and supply-side bottlenecks). Headline CPI inflation will remain near double digits for the remainder of the fiscal year, as second-round effects of high food price inflation continue to drive inflation momentum.

**45. Recent policy initiatives have reduced vulnerabilities.** The authorities have taken substantive measures in recent months to narrow external and fiscal imbalances, raise policy interest rates, move forward on structural reforms, accelerate project approvals, and manage market volatility. Of particular importance have been measures to shrink energy subsidies, allow the exchange rate to adjust, bolster capital inflows, and alleviate supply-side constraints. Continued clear communication of these policy initiatives will enhance their effectiveness.

**46. The principal risk facing India remains the inward spillover from global financial market volatility, involving a reversal of capital flows.** If capital account pressures re-emerge, then rupee flexibility should continue to be the first line of defense, complimented by the use of reserves, tightening of monetary conditions, additional fiscal consolidation efforts, and further easing of constraints on capital inflows. In addition, to prepare for further global financial market volatility, the government should design a contingency plan and communication strategy that is well-coordinated across agencies and can be rolled out in the event conditions deteriorate.

**47. High and persistent inflation remains a central macroeconomic challenge.** High inflation over the past several years has induced double-digit inflation expectations, driven a rising demand for gold, and placed downward pressure on the exchange rate. Achieving a sustained reduction in inflation will require a tightening of the monetary stance, possibly over a protracted period, which inevitably will weigh on growth prospects. Headline CPI should provide the principal nominal anchor for monetary policy, as food and fuel price shocks propagate rapidly into core inflation, and inflation expectations and wage formation are closely linked to CPI inflation.

**48. The continued opening of the capital account and rupee flexibility are welcome.** The current account deficit financing mix would be improved by enhancing the environment for FDI. However, given the potential risks to corporate balance sheets, further relaxation of limits on external commercial borrowing (especially for sectors without natural hedges) should be implemented cautiously. India's flexible exchange rate will remain important to offset substantial inflation differentials and respond to external shocks.

**49. Fiscal consolidation is essential and there is scope to improve the quality of that fiscal adjustment.** The authorities commitment to adhering to its near-term budget target is commendable. While the medium-term fiscal targets and resulting pace of consolidation are broadly

appropriate, measures still need to be articulated and implemented to underpin the targeted fiscal adjustment. Achieving this adjustment will require more efficient taxation (including through introduction of the GST) and expenditure (including through reforms to fuel and fertilizer subsidies). Steps taken to tie India's social safety net to the UID program are welcome. Reorienting spending toward 12<sup>th</sup> Plan priorities in health and education will require further reforms to fuel and fertilizer subsidies.

**50. India's financial system is well capitalized and supervised, but slowing growth has highlighted corporate vulnerabilities and led to deteriorating bank asset quality.** The RBI's recent initiatives to increase provisioning and capital requirements for bank lending to corporates with foreign currency exposures are welcome steps, as is the improved loan classification of restructured advances. A key information gap concerns the extent of unhedged foreign currency exposure of large corporates, which should be rectified. Improvements in the legal and institutional insolvency framework would also help deepen domestic capital markets.

**51. Broader structural reforms are needed to raise potential growth, particularly improvements in the pricing of natural resources.** While power distribution companies have started raising tariffs and are being restructured, the pricing of natural resources (including coal, natural gas, and fertilizer) should move toward a market basis to boost investment. In addition, removing infrastructure constraints, easing restrictive labor laws and reforming agriculture production and marketing will boost potential growth.

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

### Box 1. Debt, Inflation, and Growth<sup>1</sup>

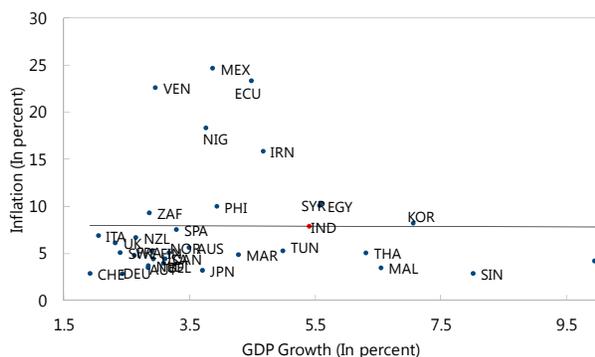
**Containing persistently-high inflation and a firm commitment to reducing the debt-generating fiscal deficits are critical for achieving higher long-term growth.** The conventional view in the literature is that public debt can stimulate aggregate demand and output in the short run, but crowds out capital and reduces output in the long run. Likewise, persistently-high inflation can be detrimental for growth. There are also possible non-linear effects where the build-up of debt or persistently-elevated inflation above a certain threshold can harm growth.

**We provide a re-examination of the debt-inflation-growth relationship using recent developments in dynamic heterogeneous panels, in a sample of 40 countries over the period 1966–2010.** Cross-country experience shows that some economies have run into debt difficulties and experienced subdued growth at relatively low debt levels, while others have been able to sustain high levels of indebtedness for prolonged periods and grow strongly without experiencing debt distress. This suggests that the effect of public debt on growth varies across countries, depending critically on country-specific factors and institutions. The estimation strategy takes into account, jointly, all three key features of panel data (i.e. dynamics, heterogeneity and cross-sectional dependence).

#### **Public debt and inflation are found to have significant negative long-run effects on growth.**

The results indicate that, if the debt-to-GDP ratio is raised and this increase turns out to be permanent, then it will have negative effects on economic growth in the long run. However, if the increase is temporary and debt-to-GDP is subsequently brought back to its normal level, then there are no long-run growth effects. Similarly, persistently-high inflation has a negative impact on long-run growth. A universally-applicable threshold effect in the relationship between either public debt or inflation and growth is not found, although a statistically-significant threshold effect for countries that have rising debt-to-GDP ratios is found. For India specifically, the estimated coefficients of debt/GDP and inflation on economic growth are -0.206 and -0.191, respectively.

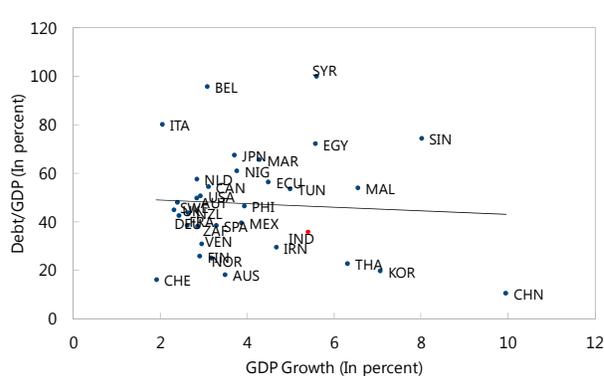
**Average GDP Growth and Inflation (1966-2010) 1/**



Sources: Chudik, Mohaddes, Pesaran and Raissi (2013).

1/ ARG, BRA, CHI, IDN, PER, and TUR were identified as outliers.

**Average GDP Growth and Debt/GDP (1966-2010)**



Sources: Chudik, Mohaddes, Pesaran and Raissi (2013).

<sup>1</sup> Prepared by Mehdi Raissi. Based on A. Chudik, K. Mohaddes, M. H. Pesaran, and M. Raissi (2013). *Debt, Inflation and Growth: Robust Estimation of Long-Run Effects in Dynamic Panel Data Models*. Federal Reserve Bank of Dallas Working Paper No. 162.

## Box 2. Financial Sector Legislative Reform Commission (FSLRC)<sup>1</sup>

### Motivation and reform strategy

In recognition of the fact that India's financial regulatory architecture dates back to the 1930s, the Ministry of Finance in March 2011 convened the FSLRC to propose reform of financial sector legislation. The aim was to identify gaps and overlaps in existing law which—combined with financial and technical innovation—could give rise to regulatory arbitrage, forum shopping, and other inefficiencies. The Commission, which submitted its report ([www.bit.ly/16svr5W](http://www.bit.ly/16svr5W)) in March 2013, proposed a new Indian Financial Code (IFC), the aim of which is to establish a single, unified legislative framework that could survive for the next 20-30 years. The principles of independence, accountability and transparency underpin the design of the IFC; for example, all new regulations would need to be justified by demonstration of the market failure they correct, and include a formal cost-benefit analysis.

### Monetary policy

The draft IFC does not specify the objective of monetary policy, but rather leaves it to the Ministry of Finance (MoF), which would issue a statement to this effect from time to time. While not enshrined in law, the objectives would be quantitative, publicly disclosed, and once set, the RBI would have instrument independence to achieve them. A formal, decision-making Monetary Policy Committee (MPC), appointed by the government and RBI, would be accountable to an empowered RBI Board (but not to parliament), with regular publication of MPC minutes. An independent debt management office would be established. Coordination between the MoF, RBI and new agencies would be handled by an upgraded Financial Sector Development Council which would have statutory authority. Capital controls would be regulated asymmetrically: MoF would regulate foreign exchange inflows while RBI would regulate outflows.

### Financial sector regulation and supervision

Given the lack of international consensus on best practice, the FSLRC settled on a model whereby a new Unified Financial Agency (UFA) would undertake consolidated supervision of the entire nonbank financial sector, including those NBFIs now supervised by the RBI. (RBI would continue to supervise banks.) The Commission felt that this approach offered the best hope of avoiding the kind of regulatory lacunae that have led to a series of challenges in recent years: unsupervised chit funds (Ponzi schemes, in effect); under-regulated credit cooperatives; unit linked insurance plans which straddle insurance and investment products; and most recently the poorly-supervised National Spot Exchange, which illegally allowed forward derivatives to be traded on its platform. Enhanced consumer protection is also a key objective of the FSLRC reforms.

Current arrangements	Proposed architecture
Reserve Bank of India (RBI)	RBI
Securities & Exchange Board of India (SEBI)	Unified Financial Agency (UFA)
Forward Markets Commission (FMC)	
Insurance Regulatory & Development Auth. (IRDA)	
Pension Fund Regulatory & Devel. Auth. (PFRDA)	

### Assessment and next steps

The FSLRC report is not uncontroversial. It has generated much debate, and some of its recommendations were the subject of formal dissents by some members of the Commission. The FSLRC report is expected to be a fulcrum for discussions on financial sector reforms for the period ahead.

<sup>1</sup> Prepared by Thomas Richardson.

### Box 3. Aadhaar: India's Unique Identification Number<sup>1</sup>

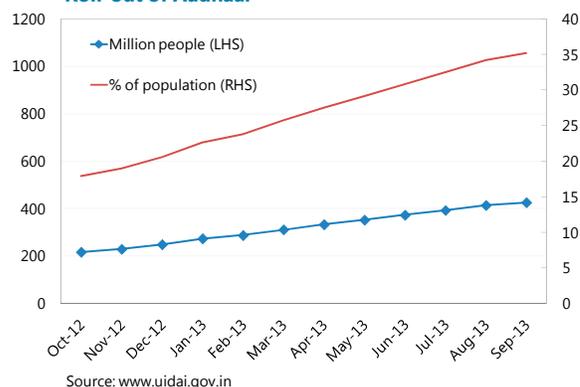
**The inability or complexity of proving who you are causes many Indian citizens to lose out on public benefits, and makes access to financial services costly or unavailable.** To address this challenge, India's Unique Identification Authority began to issue biometric identification numbers to residents in August 2010. The goal is simple, yet India's scale makes it a challenge.

**The strategy is to issue 600 million unique identification (UID or "Aadhaar") numbers by 2014, and to reach more or less full coverage by 2018** (see [bit.ly/16sigBN](http://bit.ly/16sigBN)). Aadhaar aims to leverage technology to eliminate ghosts and duplicates in subsidy rolls. Registration sites have been set up in most localities, and they can register applicants even if power is temporarily off-line. Aadhaar establishes *identity* but not *citizenship*, and signing up is voluntary. Only basic information is collected: name, date of birth, gender, parents' names (and UIDs, if available), address, and importantly biometric data: all ten fingerprints and an iris scan.

#### **It is the biometric data which renders introduction of Aadhaar at India's scale difficult.**

Each new applicant must be verified not to be one of the existing Aadhaar holders—a simple task when the number of Aadhaar holders is small, but the computational challenge grows as registration rolls out across India. Each new applicant must be *biometrically* checked against all those existing Aadhaar holders. As of September 2013, over 400 million Indians had Aadhaar numbers, and as many as 800,000 to 1 million new enrollees are added daily.

Roll-out of Aadhaar



**Potential fiscal gains from introduction of Aadhaar include savings on subsidies due to "deduplication" of beneficiary rolls (e.g., elimination of ghosts), particularly as benefits are meant to be deposited directly into special "no-frills" bank accounts for beneficiaries.** Thus far, 23 million bank accounts have been linked to Aadhaar numbers, but that figure is expected to rise to 100 million by end-2013. Eventually Aadhaar will also contribute to better revenue performance when it is integrated with direct and indirect tax databases.

**Financial inclusion is an important objective of Aadhaar.** As of 2010, only about 200–250 million Indian citizens had bank accounts. Aadhaar has been approved by the RBI as a way to satisfy "know your customer" (KYC) norms, and the UID Authority is working with financial regulators to enable electronic, or e-KYC, platforms. Among other things, it is expected that Aadhaar will enhance the coverage and therefore usefulness of the Credit Bureau, making access to financial products more readily available to Indian citizens.

<sup>1</sup> Prepared by Thomas Richardson.

### Box 4. Food Security Act: Fiscal Implications<sup>1</sup>

**The National Food Security Act is an important effort to ensure that the majority of India's population has access to adequate quantities of food at affordable prices.** The legislation is a landmark, representing the largest food security program in the world, involving the distribution of subsidized grain to two-thirds of India's population of 1.2 billion persons. It proposes to cover up to 75 percent of the rural population, and up to 50 percent of the urban population, with an entitlement of 5 kg per person per month of food grains at issue prices of Rs. 2 and 3 per kg for wheat and rice, respectively. Nonetheless, the Act has been introduced at a time when international experience indicates that conditional cash transfers, rather than physical distribution of subsidized food, have been found to be a more efficient means of achieving food and nutritional security.

**The fiscal implications of the Food Security Act (FSA) are likely to be significant.** The food subsidy cost of implementing the FSA is estimated at Rs. 124,502 crores (about 1.1 percent of GDP) for fiscal year 2013/14. The food subsidy is calculated as [economic cost-issue price]\*foodgrain requirement. The "economic cost" (as computed by the Food Corporation of India) includes, in addition to the minimum support price (MSP) paid to farmers, handling, storage and distribution costs. The "issue price" is the sale price of grain to consumers; the "foodgrain requirement" is the quantity of foodgrains required under the FSA. Food subsidy costs are estimated to increase to Rs. 140,192 and Rs. 157,701 crores, both about 1.1 percent of GDP, respectively, in FY 2014/15 and FY 2015/16. The "incremental" food subsidy under the FSA—over and above the subsidy that is already provided under the existing Targeted Public Distribution System (TPDS, see details below)—is estimated at Rs. 23,951 crores (equivalent to about 0.2 percent of FY 2013/14 GDP).

**However, the FSA needs to be carefully evaluated to take into account not only the cost of the food subsidy,** but also three additional cost dimensions, which can potentially magnify the fiscal implications of the FSA (see Table 1).

- First, if implementation of the FSA includes "grand-fathering" of existing beneficiaries, even when their income levels may imply that they no longer qualify for the FSA program, then the estimated fiscal cost could be higher.
- Second, if implementation of the FSA requires merging the current classification under the TPDS with new and more careful identification schemes, then there may be misclassifications which could raise costs. For example, there may be pressure to expand the size of those classified as "covered" under FSA to include those who are not truly poor, but are misclassified as such under the current scheme.

**Table 1. Summary Table: Incremental Cost of Food Security Act Relative to Targeted Public Distribution, 2013-14 (Rs. Crores)**

1/ Baseline	23,951
Additional Costs Relative to Baseline	
2/ Grandfathering	20,474
3/ Misclassification	11,301
4/ Miscellaneous expenditures	20,760
<b>1/+2/+3/+4/</b>	<b>76,486</b>
<i>% of GDP</i>	<i>0.67</i>
5/ 40% additional procurement	4,925
<b>1/+2+3/+4/+5/</b>	<b>81,411</b>
<i>% of GDP</i>	<i>0.72</i>

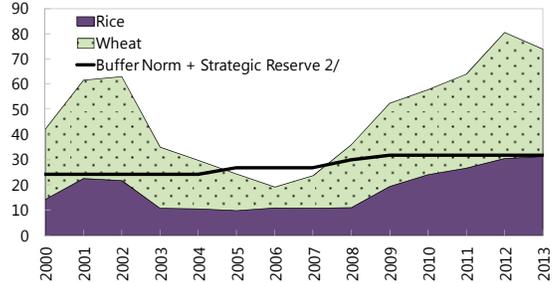
Source: Mishra (2013).

<sup>1</sup> Prepared by Prachi Mishra (MCM) and Paul Cashin. This Box draws on P. Mishra (2013), "Financial and Distributional Implications of the Food Security Law", *Economic and Political Weekly*, Vol. XLVIII, No. 39, September 28, 2013.

**Box 4. Food Security Act: Fiscal Implications (concluded)**

- Third, the open-ended procurement policies of the government (whereby the government commits to buying unlimited quantities of wheat and rice at the MSP) have implied that procurement has typically been much higher than the required quantity of food grains needed for public distribution programs. For example, on average over the last 10 years (between 2002–03 and 2011–12), procurement has been 40 percent higher than the off-take from the public distribution system. If we add these costs of additional procurement to the incremental food grain requirement in the FSA, the estimated fiscal cost can increase substantially. The carrying cost of excessive grain stocks is large and increasing.

**Grain Stocks Held in Central Pool by Food Corporation of India 1/**  
(In millions of tons)

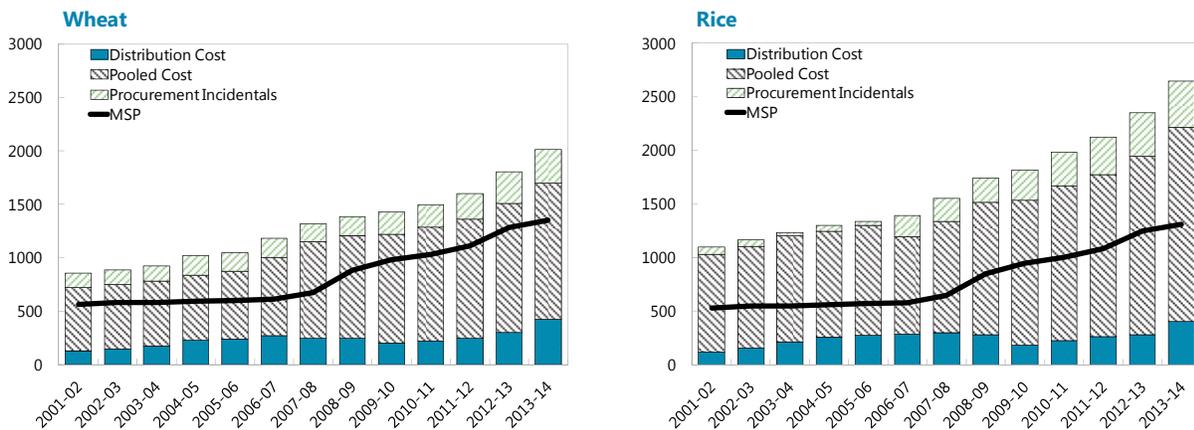


Source: Food Corporation of India.  
1/ Data as of 1st of July for each year.  
2/ Includes buffer norms and strategic reserve for rice and wheat.

**These estimates of the incremental costs of the FSA should be seen as tentative, as the precise costs of the current TPDS (and additional welfare) schemes are not easy to calculate.** Given the experience that off take increases when grain is offered at very low prices, and that the estimates do not include various additional expenditures stated in the Act which are difficult to quantify, the calculations here are likely to be underestimates. Indeed, other sources have estimated higher fiscal costs of the FSA.<sup>2</sup> Nonetheless, full implementation of the FSA is unlikely to happen in FY 2013/14, hence the immediate implications for the government’s fiscal position will likely be more limited.

**Economic Cost and Minimum Support Price (MSP) 1/**

In Rs. Per Quintal (100 kilograms)



Sources: Food Corporation of India; and Commission for Agricultural Costs and Prices.

1/ The economic cost is the sum of the distribution cost and acquisition cost (comprising pooled cost incl. imports and procurement incidentals).

<sup>2</sup> See A. Gulati, J. Gujral, and T. Nandakumar, 2012, “National Food Security Bill: Challenges and Options”, Discussion Paper No. 2, Commission for Agricultural Costs and Prices, Ministry of Agriculture.

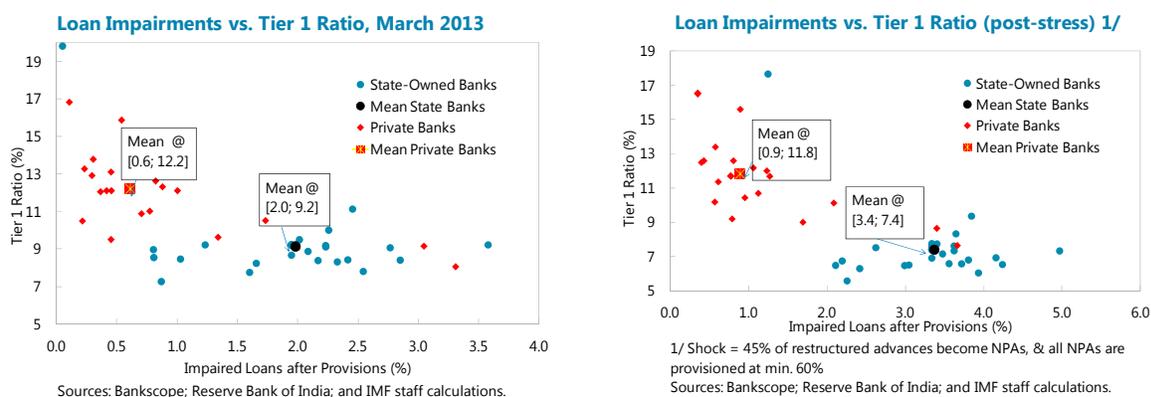
### Box 5. The Potential Capital Needs of India's Commercial Banking Sector<sup>1</sup>

**Although manageable, India's banks are likely to require significant new capital injections over the next few years, based on the challenging operating environment, combined with the new Basel III capital requirements.** The challenges on the business front are embodied in the fast-increasing restructured advances, which now (as of March 2013) comprise 5.7 percent of the banking systems' gross advances, and 7.1 percent of the Public Sector Banks' (PSBs) advances. Restructured assets are usually not considered 'non-performing' in India, and their rapid rise has led some observers to doubt the publicly displayed financial strength of many Indian banks. Here we stress-test the banks' capital position with regard to sudden deterioration in loan quality, and evaluate the impact of Basel III requirements via a dynamic simulation approach.

**A stress test of banks' balance sheets found the PSBs in particular vulnerable to a change in classification on a significant share of restructured loans to non-performing assets (NPAs).** Each bank's balance sheet was stressed individually, based on 45 percent of restructured advances moving to NPAs, and those NPAs being provisioned against loss at a minimum 60 percent.<sup>2 3</sup> All banks are compared with regards to their Tier 1 capital ratio and their ratio of impaired loans after provisions. As of March 2013, the average Tier 1 ratio is more than 3 percent higher for private sector banks than for public banks, with private banks' impaired-loans-to-provisions ratio almost 1.4 percent lower. Moving from the March 2013 data points to the post-stress data, the average Tier 1 ratio decreased by about 1.7 percent for the PSBs, and less than 0.4 percent for the private sector banks, respectively. Mean impaired loans after provisions increased by almost 1.4 percent for PSBs, and less than 0.3 percent for private banks. The figure below also shows how the banks location in Tier 1 – Impaired Loans after Provisions space shifts, with the PSBs moving significantly to the right.

#### Loan Impairments across India's Private and Public Sector Banks

(As of March 2013 and post-stress event)



<sup>1</sup> Prepared by Peter Lindner (MCM).

<sup>2</sup> The average provisioning ratio of private sector banks is slightly above 60 percent; this provisioning ratio was used as a minimum. If a bank's provisioning ratio for 2012/13 exceeded that number, its actual number was used.

<sup>3</sup> Historically, about 15 percent of restructured advances have moved into NPAs, with the authorities having used a maximum 30 percent transition rate in their stress tests.

### Box 5. The Potential Capital Needs of India's Commercial Banking Sector (concluded)

**Employing more severe scenario assumptions illustrates the potential for significantly higher potential recapitalization costs for the government.** Assuming that both the PSBs' NPAs and their restructured loans double, with three alternative provisioning ratio scenarios assumed (restructured loans provisioned at 50 percent, both restructured loans and the existing NPAs at 75 percent, and both at 100 percent), and under a 7 percent Tier 1 target capital ratio for all PSBs, Table 1 illustrates these results. In the most severe case, the government's share of the recapitalization cost would amount to 5 percent of FY2012–13 GDP.

**Table 1. Cost of PSB Recapitalization under Severe Stress**

(In percent of 2012–13 GDP)

	Scenario 1	Scenario 2	Scenario 3
Public Sector Share	2.1	3.5	5.0
Total	3.3	5.5	7.9

Source: Bankscope and IMF staff calculations.

**The additional bank capital that will need to be raised for the PSB's based on Basel III capital requirements will likely be moderate** (Table 2). The capital needs of banks will increase with faster credit growth, and with the amount that banks desire to hold above the March 2018 Tier 1 capital ratio of 7 percent. For alternative values of this cushion—0, 1, and 2 percent—and using return on assets (ROA) or return on equity (ROE) as the profit driver, the cost for the central government does not exceed 2 percent of FY 2017–18 GDP.<sup>4</sup> The cells reflecting results of scenarios deemed more plausible are highlighted in Table 2.

**Table 2. Indian Banks' Recapitalization Costs under Basel III: Additional Capital Requirements as Percent of 2018 GDP<sup>1/ 2/</sup>**

ROA-Based Simulations				ROE-Based Simulations			
Total Capital in 2018 (%) <sup>3/</sup>	Credit Growth (Multiple of GDP Growth)			Total Capital in 2018 (%) <sup>3/</sup>	Credit Growth (Multiple of GDP Growth)		
	Slow (~GDP)	Base (~1.5*GDP)	Fast (~2*GDP)		Slow (~GDP)	Base (~1.5*GDP)	Fast (~2*GDP)
	<b>Government's Share</b>				<b>Government's Share</b>		
7 (0)	0.00	0.11	0.62	7 (0)	0.02	0.31	1.07
8 (1)	0.06	0.36	1.01	8 (1)	0.14	0.62	1.47
9 (2)	0.22	0.66	1.41	9 (2)	0.35	0.92	1.87
<b>Total for Public Sector Banks</b>				<b>Total for Public Sector Banks</b>			
7 (0)	0.00	0.17	0.96	7 (0)	0.03	0.49	1.67
8 (1)	0.09	0.55	1.58	8 (1)	0.21	0.96	2.29
9 (2)	0.34	1.02	2.20	9 (2)	0.54	1.44	2.91
<b>Total for Private Banks</b>				<b>Total for Private Banks</b>			
7 (0)	0.00	0.00	0.04	7 (0)	0.00	0.00	0.13
8 (1)	0.00	0.01	0.16	8 (1)	0.00	0.02	0.31
9 (2)	0.01	0.06	0.35	9 (2)	0.01	0.09	0.52

Source: RBI, BankScope, Staff calculations

1/ Simulations based on 2012 data (except ROA and ROE, where 2011 & 2012 averages are used)

2/ A 15 percent transition rate from restructured loans to NPAs is assumed

3/ Numbers equal Equity Tier 1 ratio plus Capital Conservation Buffer plus additional cushion of 0, 1, or 2 percentage points

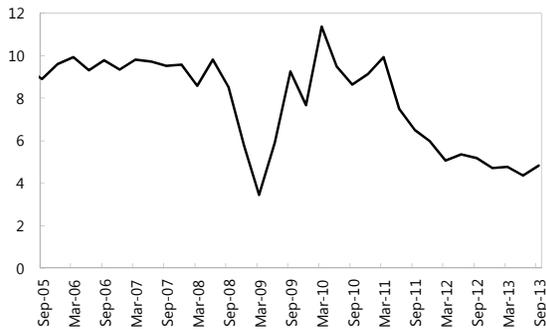
<sup>4</sup> Simulations are based on stock values at end-March 2013; returns and other flow variables are averaged across fiscal years 2012 and 2013.

### Figure 1. India: Growth and Activity

Growth remains subdued and will likely recover only slowly.

GDP growth continues to be sluggish.

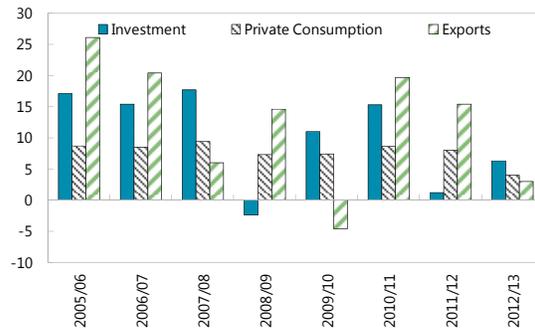
**GDP Growth**  
(In percent, yoy)



Sources: CEIC and IMF staff calculations.

The slowdown is broad-based, with consumption and investment growth remaining weak.

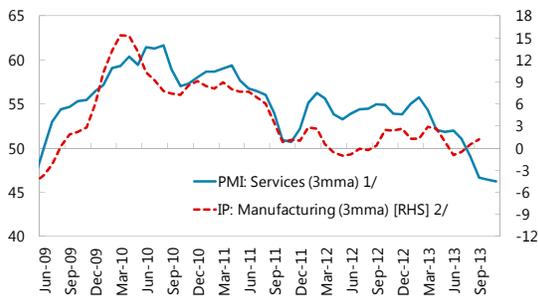
**Demand Components of GDP**  
(In percent, yoy)



Sources: CEIC and IMF staff calculations.

High-frequency activity indicators point to a weak recovery.

**Activity: Manufacturing and Services**

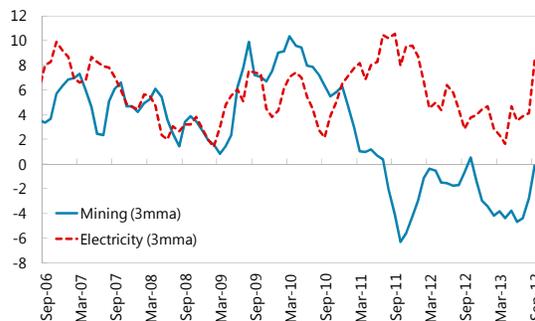


1/ SA, 50+ = Expansion.  
2/ YoY percent change.

Sources: Haver Analytics; and IMF staff calculations.

Supply bottlenecks have been a drag on growth.

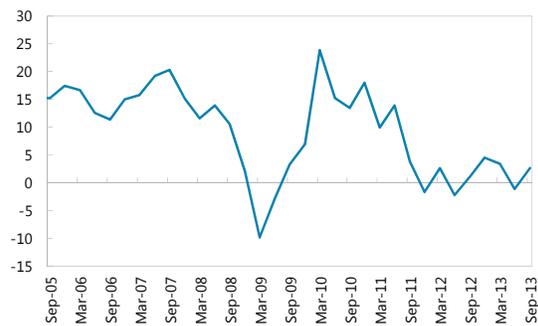
**Production: Mining & Electricity**  
(Percent change, yoy)



Sources: CEIC and IMF staff calculations.

Investment growth is anemic...

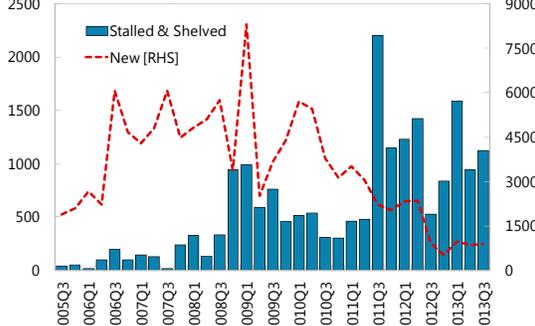
**Gross Fixed Capital Formation, Real**  
(yoy percent change)



Source: Haver Analytics.

...and the pipeline of new projects remains thin.

**Investment**  
(In billions of Rupees)



Sources: CAPEX and IMF staff calculations.

### Figure 2: India: Recent Developments: International Perspective

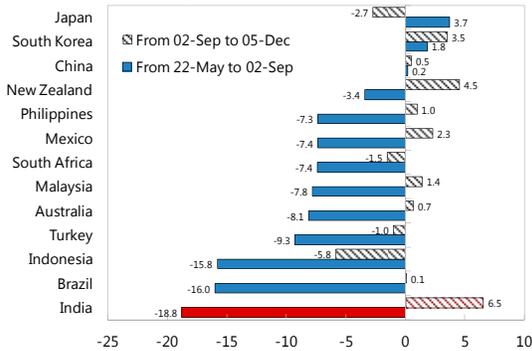
Among emerging market economies, India was among those affected by recent global liquidity tightening.

After sharp depreciation through end-August, the rupee has recovered more recently.

India's stock market has also recovered since end-August.

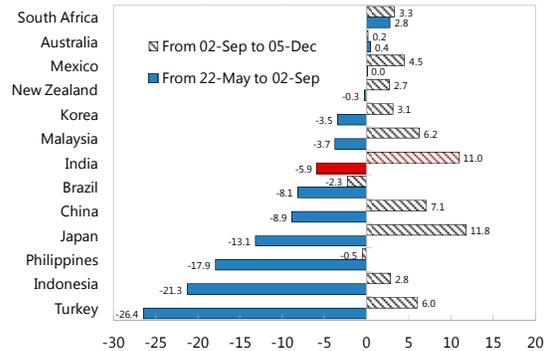
#### Local Currency per US\$

(Percent Change, + = local currency appreciation)



#### Equity Market Indices

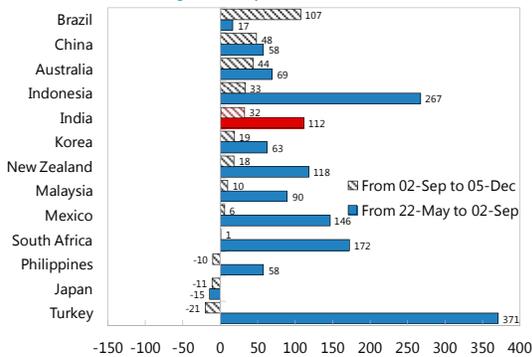
(Percent change since May 22, 2013)



Long-term government bond yields have widened.

#### 10-Year Domestic Bond Yields

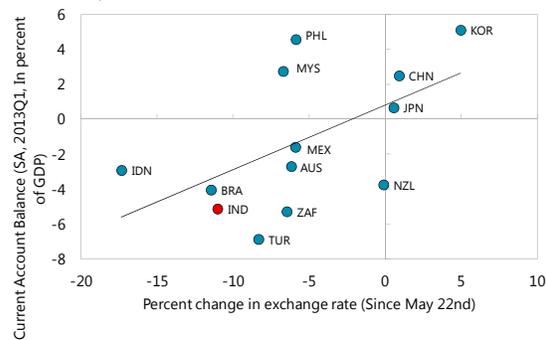
(BPS change since May 22, 2013)



Recent developments in part reflect India's weaker external position...

#### Current Account Balance vs. Exchange Rate

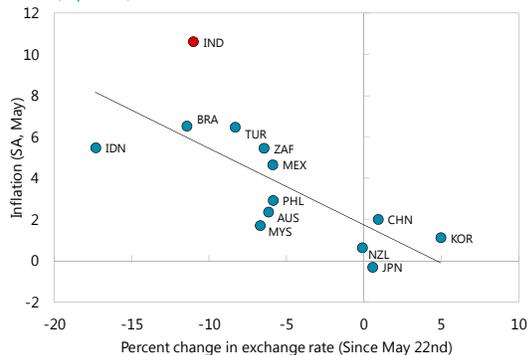
(In percent)



...and narrower monetary policy space...

#### Inflation vs. Exchange Rate

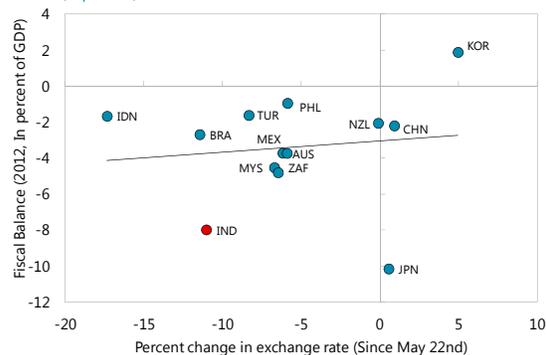
(In percent)



...and a larger fiscal deficit.

#### Fiscal Balance vs. Exchange Rate

(In percent of GDP)



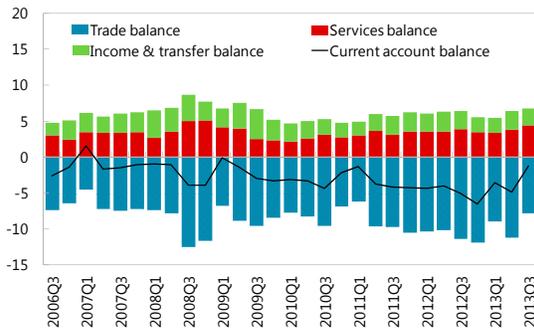
Sources: Bloomberg, IMF World Economic Outlook, Haver Analytics, and IMF staff calculations.

### Figure 3. India: External Vulnerabilities

External risks have abated somewhat and are manageable.

The current account deficit has improved after widening to a historical high on the back of a large trade deficit.

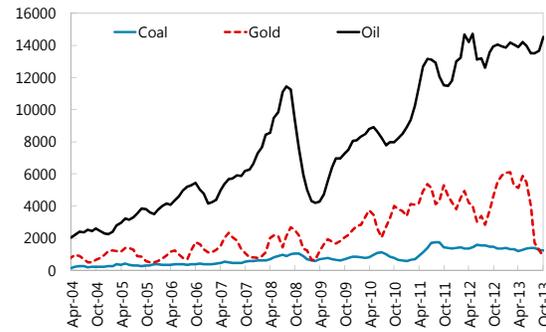
**Current Account Balance**  
(In percent of GDP)



Sources: CEIC and IMF staff calculations.

Supply constraints led to a surge in fuel and coal imports. Measures to curb gold imports have worked.

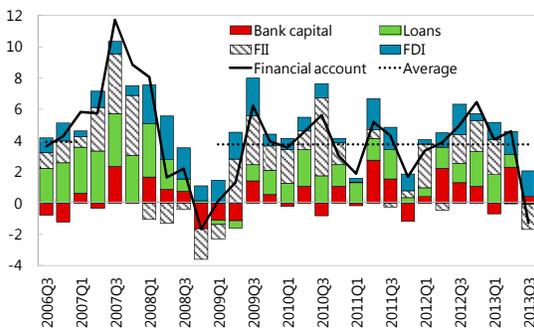
**Imports: Principle Commodities**  
(In millions of US Dollars, 3mma)



Sources: CEIC; and IMF staff calculations.

Financing of the current account deficit has become challenging...

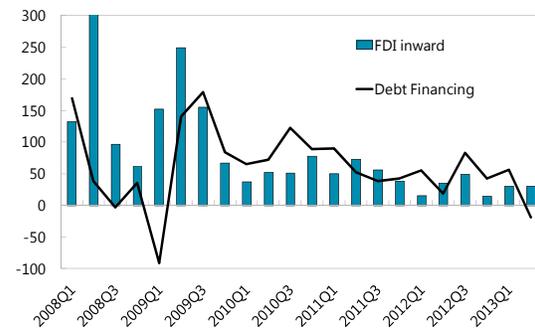
**Financial Account**  
(In percent of GDP)



Sources: CEIC; and IMF staff calculations.

...as the composition has shifted away from FDI toward debt.

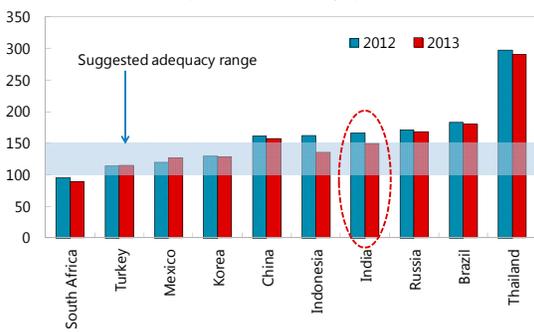
**Inward FDI and Debt Financing**  
(In percent of Current Account Deficit)



Source: Haver Analytics.

Reserve coverage is adequate...

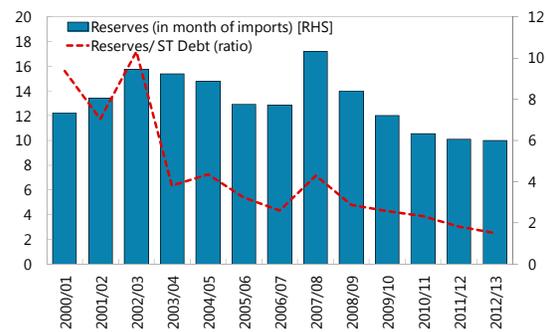
**Estimated Reserve Adequacy**  
(Official reserves as a percent of IMF country-specific metric)



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

...but has been falling.

**Reserves Coverage**



Sources: IMF staff calculations.

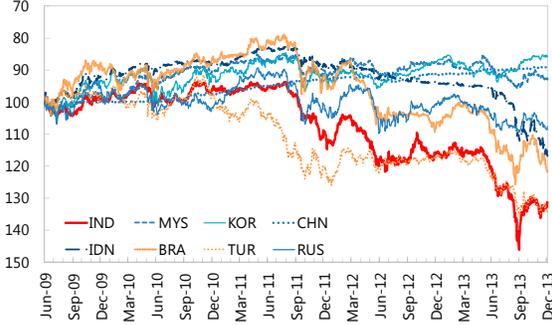
**Figure 4. India: Financial Markets**

*Global financial market volatility led to capital outflows, but flows have stabilized lately.*

*The rupee has depreciated on concerns of a large current account deficit and global risk reversal...*

**Exchange Rate**

(Index, June 1, 2009=100, NC/US\$)

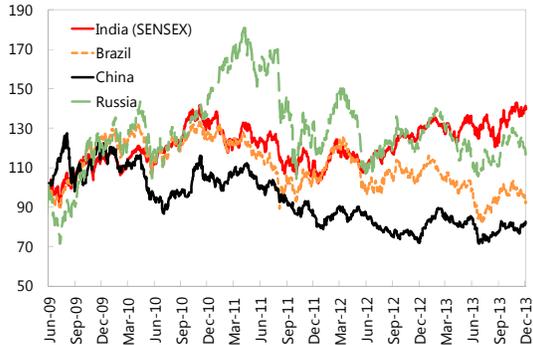


Sources: Bloomberg and IMF staff calculations.

*Although stock market index has been relatively stable...*

**Stock Market Indices**

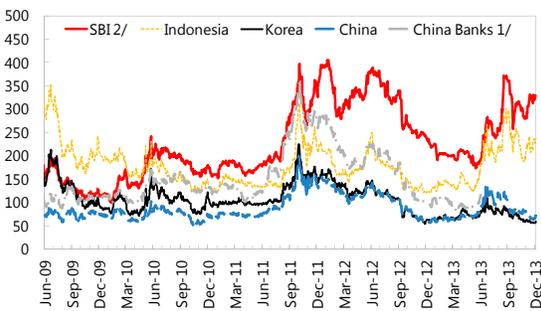
(June 1, 2009 = 100)



*Spreads on the proxy CDS for the Indian sovereign have spiked.*

**Credit Default Swap: SBI versus Sovereigns**

(Basis points)



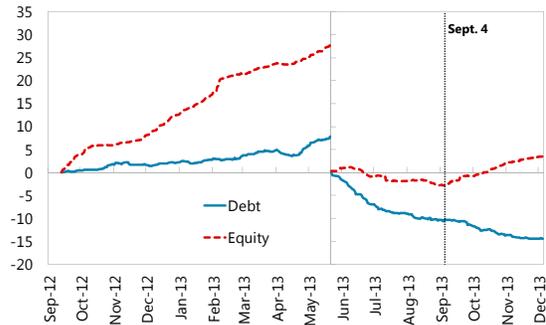
1/ Average of Bank of China and China Development Bank.  
2/ SBI is used as proxy for Government of India.

Sources: Bloomberg, CEIC, and IMF staff calculations.

*...accompanied (as with most emerging market economies) by sizable portfolio debt outflows.*

**Debt and Equity Inflows**

(In billions of US Dollars, cumulative)

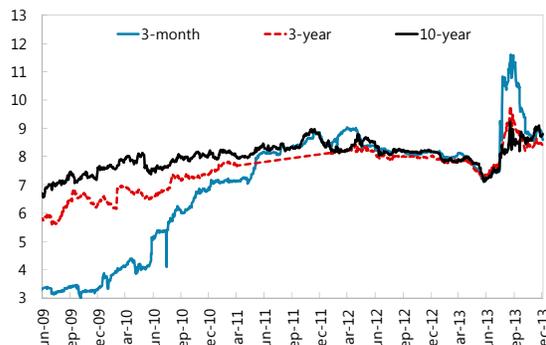


Source: Bloomberg.

*...bond yields ticked up, partly due to RBI's liquidity tightening measures.*

**Bond Yields**

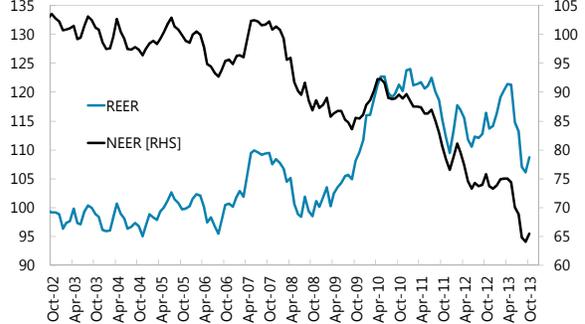
(In percent)



*Despite recent depreciation, India's high inflation differential has kept real effective exchange rate high.*

**Nominal and Real Effective Exchange Rates**

(Index, 2005=100)



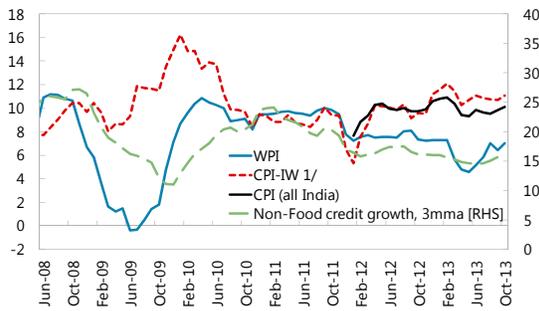
Sources: IMF, Information Notice System and IMF staff estimates.

**Figure 5. India: Monetary Developments**

*Inflation has picked up even as the output gap has widened. Upside risks to inflation emanating from elevated food inflation, rupee depreciation, and inflation expectations remain high.*

*CPI and WPI inflation have been picking up and remain elevated...*

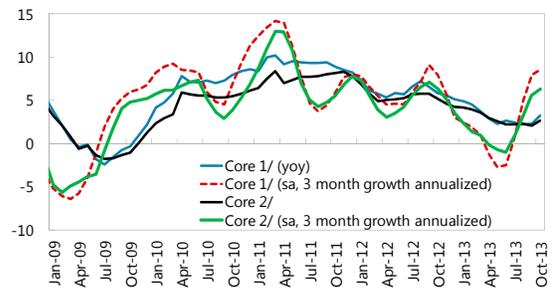
**Inflation and Credit**  
(In percent, yoy)



1/ Industrial Workers  
Sources: CEIC and IMF staff calculations.

*...and core WPI inflation momentum has started to increase again.*

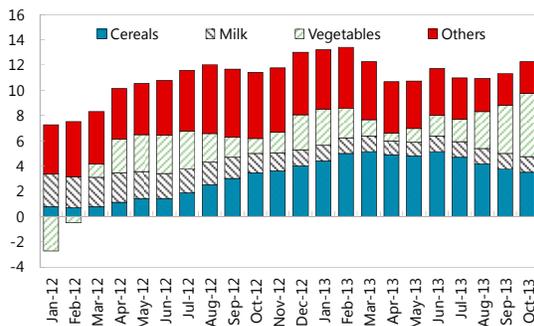
**WPI: Core Inflation Trend**  
(In percent)



1/ Excluding foods and energy.  
2/ Manufacturing excluding foods.  
Sources: CEIC and IMF staff calculations.

*Food inflation remains high.*

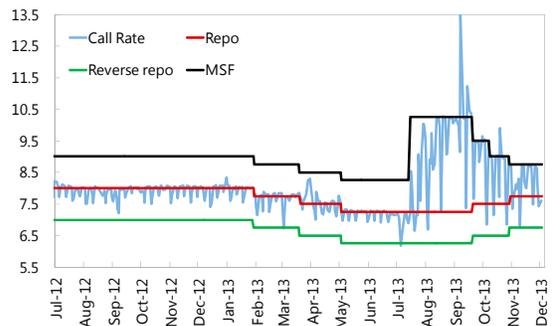
**CPI Food Inflation: Contributions**  
(In percent, yoy)



Sources: CEIC and IMF staff calculations.

*Money market rates rose significantly above the policy rate...*

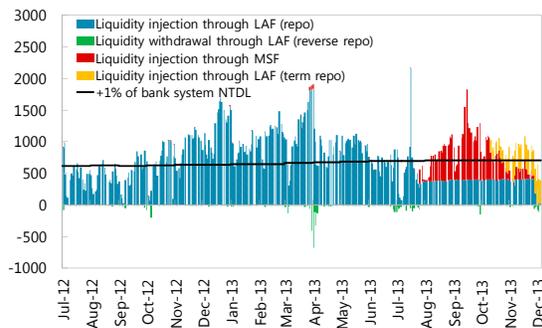
**Interest Rates**  
(In percent)



Source: Bloomberg.

*...following RBI's liquidity tightening measures, but they were largely unwound more recently...*

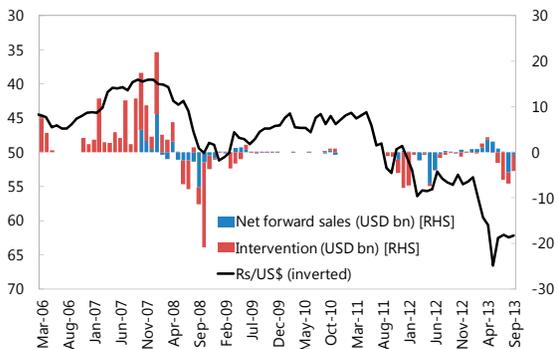
**Daily Liquidity Operations**  
(In billions of Rupees)



Source: CEIC.

*...while intervention has been limited.*

**Exchange Rate and Intervention**



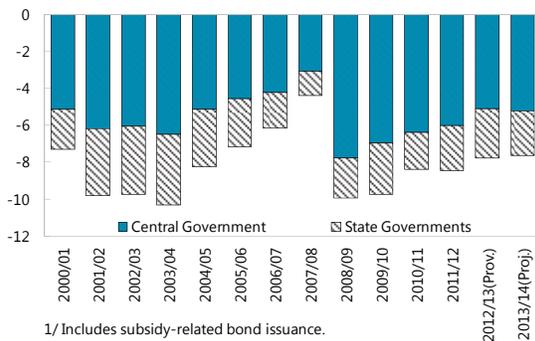
Sources: CEIC; Bloomberg; and IMF staff calculations

**Figure 6. India: Fiscal Sector Developments**

*Fiscal consolidation after the financial crisis continues. Ensuring stable debt dynamics will require measures to contain current expenditure and raise revenue.*

*The budget deficit has been slowly declining but remains high.*

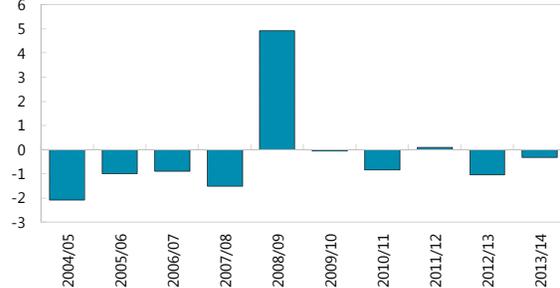
**Government Balance**  
(In percent of GDP) 1/



1/ Includes subsidy-related bond issuance.  
Source: IMF staff data.

*Following the rapid post-global crisis expansion, the fiscal stance has been broadly neutral.*

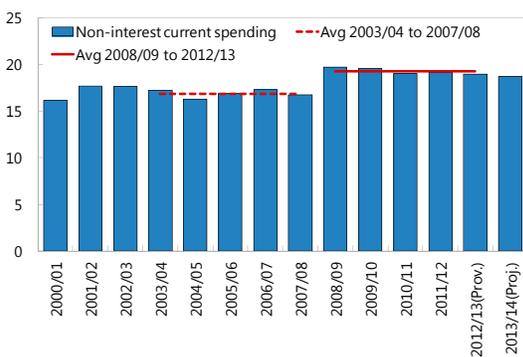
**General Government Fiscal Impulse 1/**  
(In percent of GDP)



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

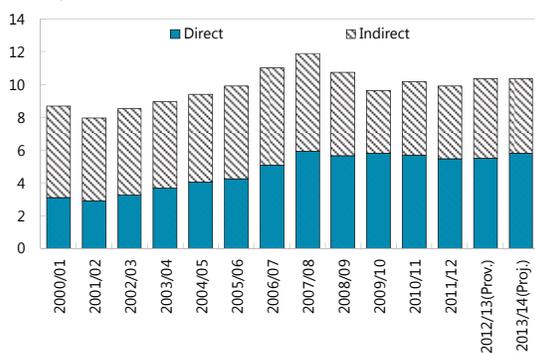
*Current spending reached a new plateau during the crisis and has fallen only slowly.*

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



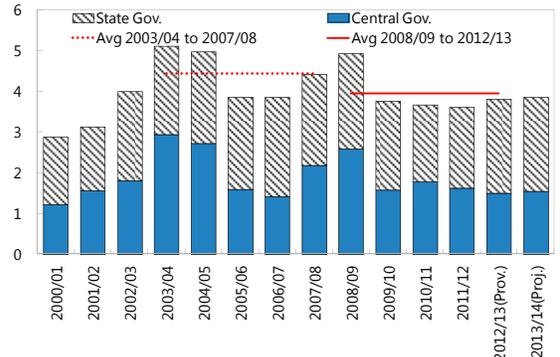
*And revenue mobilization has suffered.*

**Central Government Revenue**  
(In percent of GDP)



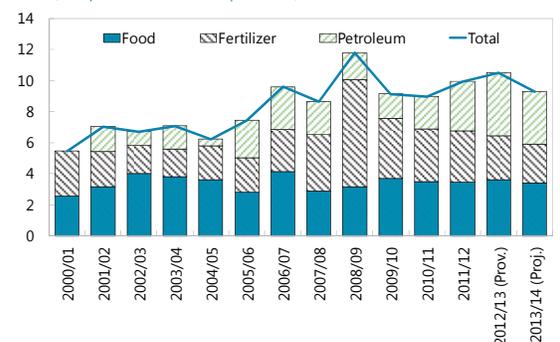
*However, capital spending is lower than pre-crisis levels.*

**Capital Spending**  
(In percent of GDP)



*Reaching medium-term deficit targets will require comprehensive subsidy reform.*

**Government Subsidies**  
(As a percent of Current Expenditure)



Sources: IMF staff data.

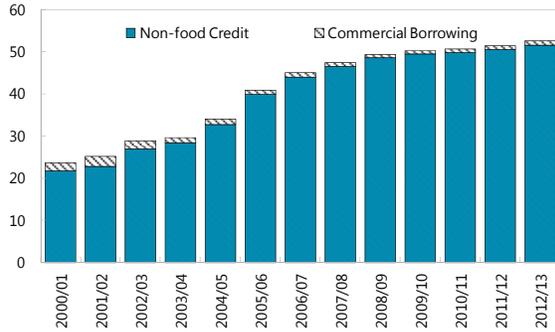
Sources: Indian authorities; and IMF staff calculations.

**Figure 7. India: Corporate and Banking Sectors**

*Corporate sector stresses remain high, causing a further deterioration of banks' asset quality.*

*Corporate borrowing is still increasing...*

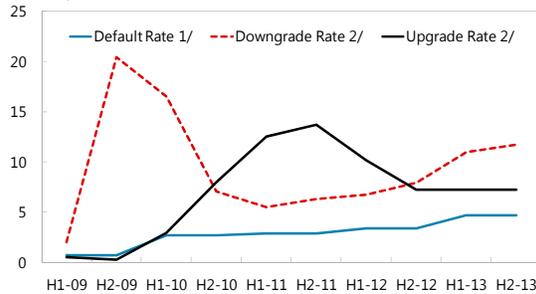
**Corporate Borrowing**  
(In percent of GDP)



Sources: CEIC and IMF staff calculations.

*Upgrade rate has stabilized at a lower level, while default and downgrade continue to rise.*

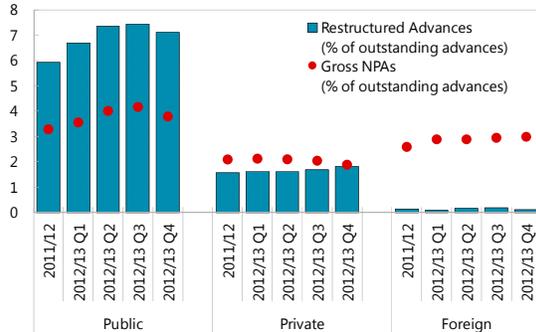
**Default, Downgrade, and Upgrade Rate**  
(In percent, annualized)



H1-09 H2-09 H1-10 H2-10 H1-11 H2-11 H1-12 H2-12 H1-13 H2-13  
1/ Share of S&P-rated companies defaulting per semester.  
2/ Share of S&P-rated companies downgraded or upgraded per semester.  
Sources: Crisil Ratings and IMF staff calculations.

*...and have higher exposure to restructured loans.*

**Commercial Banks: Restructured Advances & NPAs**  
(In percent)

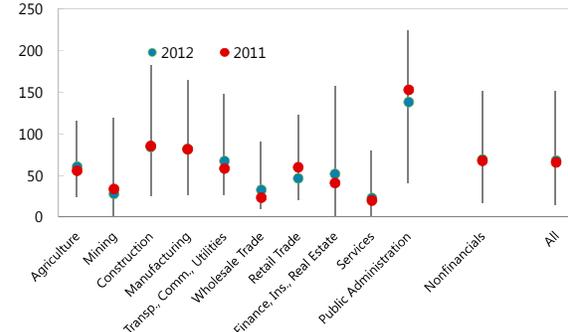


Sources: Reserve Bank of India and IMF staff calculations.

*...with leverage rising particularly in the transportation, communications, utilities and the public sector.*

**Leverage Ratios by Sector**

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

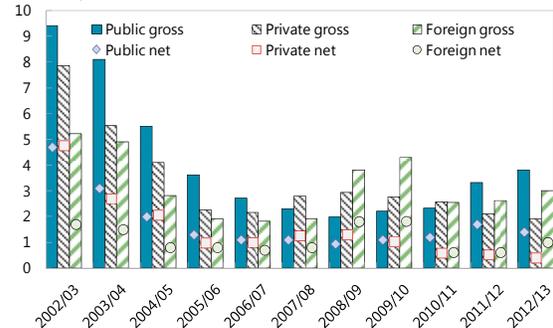


Sources: IMF, Corporate Vulnerability Utility; and IMF staff calculations.

*Public sector banks are bearing the brunt of the increase in NPAs...*

**Commercial Banks NPAs**

(In percent)

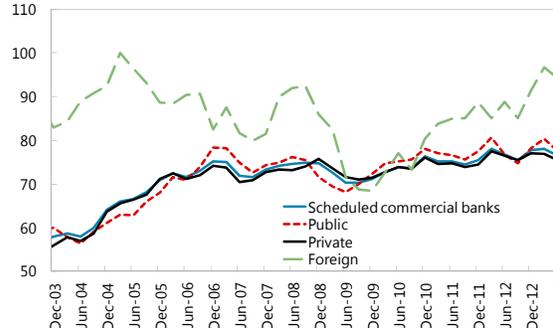


Sources: Reserve Bank of India and IMF staff calculations.

*The loan-to-deposit ratio has recently declined, and the gap between private and public banks has narrowed.*

**Loan to Deposit Ratio**

(In percent)



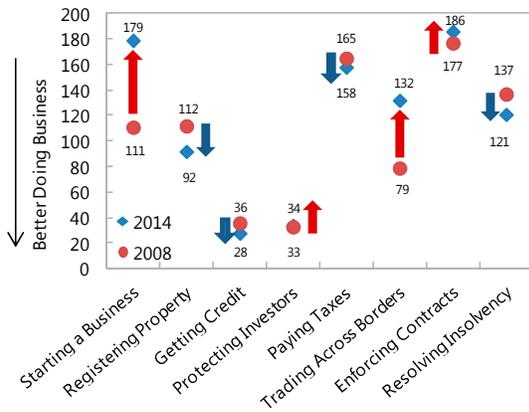
Sources: CEIC and IMF staff calculations.

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

**Figure 8. India: Business Environment and Governance**

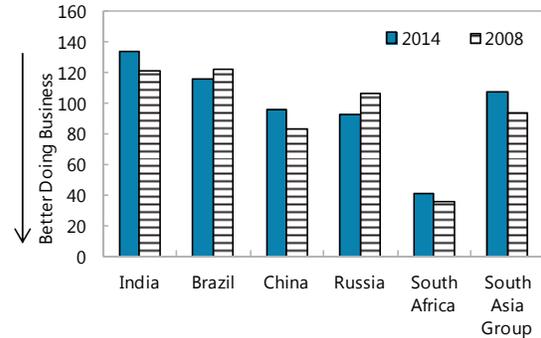
India compares poorly with other emerging market economies in various competitiveness surveys.

**Evolution of Doing Business Indicators Ranking: India**



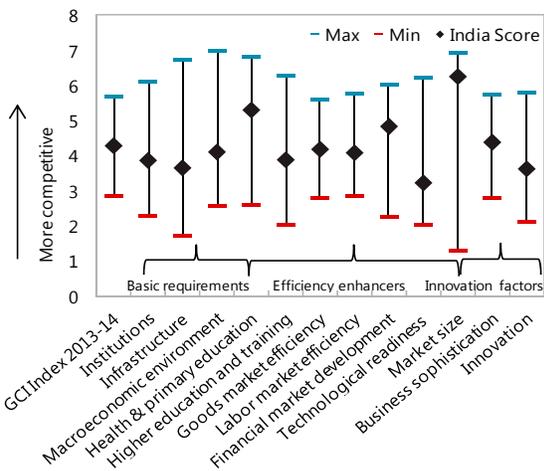
Sources: World Bank, Doing Business Report (2014 and 2008)

**Ease of Doing Business Ranking: BRICS and South Asia**



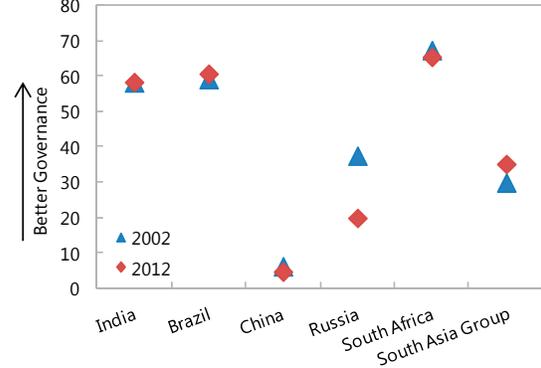
Sources: World Bank, Doing Business Report (2014 and 2008)  
Note: South Asia Group includes Bhutan, Maldives, Nepal, Pakistan and Sri Lanka.

**2013-14 India Scores in Global Competitiveness Index and Pillars**



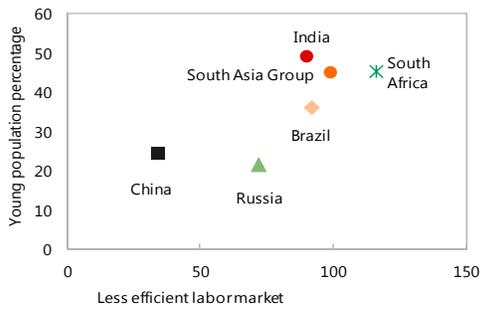
Sources: World Economic Forum Global Competitiveness Report (2013-14)

**Voice and Accountability: BRICS and South Asia (Percentile rank)**



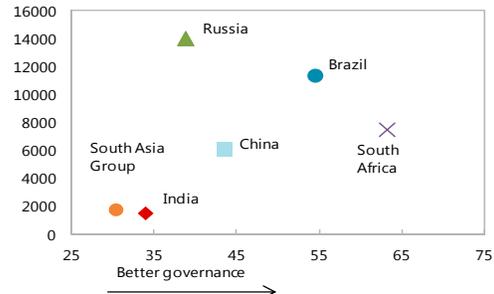
Sources: Worldwide Governance Indicators 2013  
Note: South Asia Group includes Bhutan, Maldives, Nepal, Pakistan and Sri Lanka.

**Labor Market Efficiency Ranking and Young Population Ratio: BRICS and South Asia**  
(Young population ratio: in percent of working-age population)



Sources: World Development Indicators (2012) and World Economic Forum Global Competitiveness Report (2013)  
Note: 1/ Young, defined as people younger than 15; working-age population as 15-64.  
2/ South Asia Group includes Bhutan, Nepal, Pakistan and Sri Lanka

**Regulatory Quality and GDP Per Capita: BRICS and South Asia 2012**  
(Percentile rank; in US Dollars)



Sources: Worldwide Governance Indicators 2013 and World Development Indicators 2012  
Note: 1/ Regulatory quality effects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector;  
2/ South Asia Group includes Bhutan, Maldives, Nepal, Pakistan and Sri Lanka.

**Table 1. India: Millennium Development Goals, 1990-2012 1/**

	1990	2004	2006	2008	2009	2010	2011	2012
<b>Eradicate extreme poverty and hunger 2/</b>								
Income share held by lowest 20%	...	...	8.6	...	...	8.5	...	...
Malnutrition prevalence, weight for age (% of children under 5)	59.5	...	43.5	...	...	28.8	...	...
Poverty gap at \$1.25 a day (PPP) (%)	...	...	10.5	...	...	7.5	...	...
Poverty headcount ratio at \$1.25 a day (PPP) (% of population)	...	...	41.6	...	...	32.7	...	...
Poverty headcount ratio at national poverty line (% of population)	...	37.2	...	...	...	29.8	...	...
Prevalence of undernourishment (% of population)	...	...	...	19.0	18.8	18.3	17.5	...
<b>Achieve universal primary education 3/</b>								
Literacy rate, youth total (% of people ages 15-24)	61.9	...	81.1	...	...	...	...	...
Persistence to grade 5, total (% of cohort)	...	65.8	68.5	...	...	...	...	...
Primary completion rate, total (% of relevant age group)	...	84.1	86.7	95.7	...	...	...	...
School enrollment, primary (% net)	...	89.9	89.4	92.1	...	...	...	...
<b>Promote gender equality 4/</b>								
Proportion of seats held by women in national parliament (%)	5	9	8	9	11	11	11	11
Ratio of girls to boys in primary and secondary education (%)	...	90	90	94	96	96	...	...
Ratio of young literate females to males (% ages 15-24)	67	...	84	...	...	...	...	...
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	13	18	18	...	...	...	...	...
<b>Reduce child mortality 5/</b>								
Immunization, measles (% of children ages 12-23 months)	56	61	70	74	74	74	74	...
Mortality rate, infant (per 1,000 live births)	81	58	54	51	50	49	47	...
Mortality rate, under-5 (per 1,000)	114	77	72	68	66	63	61	...
<b>Improved maternal health 6/</b>								
Births attended by skilled health staff (% of total)	...	...	47	52	...	...	...	...
Maternal mortality ratio (modeled estimate, per 100,000 live births)	600	...	280	...	...	200	...	...
<b>Combat HIV/AIDS, malaria, and other diseases 7/</b>								
Contraceptive prevalence (% of women ages 15-49)	43	53	56	55	...	...	...	...
Incidence of tuberculosis (per 100,000 people)	216	212	205	196	190	185	181	...
Prevalence of HIV, female (% ages 15-24)	...	...	...	...	0.1	...	...	...
Prevalence of HIV, total (% of population ages 15-49)	0.1	0.4	0.4	0.3	0.3	...	...	...
<b>Ensure environmental sustainability 8/</b>								
CO2 emissions (metric tons per capita)	0.8	1.2	1.3	1.5	1.7	...	...	...
Forest area (% of land area)	21.5	...	22.8	...	...	23.0	23.1	...
GDP per unit of energy use (constant 2005 PPP \$ per kg of oil equivalent)	3.3	4.4	4.9	5.1	5.0	5.4	...	...
Improved sanitation facilities (% of population with access)	18	29	31	32	33	34	35	...
Improved water source (% of population with access)	69	85	88	90	91	91	92	...
<b>Develop a global partnership for development 9/</b>								
Fixed line and mobile phone subscribers (per 100 people)	0.6	8.8	17.9	32.3	46.6	64.3	74.6	...
Internet users (per 100 people)	0.0	2.0	2.8	4.4	5.1	7.5	10.1	...
Total debt service (% of exports of goods, services and income)	34.9	14.5	8.6	9.6	6.0	5.6	...	...
Unemployment, youth female (% of female labor force ages 15-24)	...	10.8	10.8	...	...	11.5	...	...
Unemployment, youth male (% of male labor force ages 15-24)	...	10.4	10.4	...	...	9.8	...	...
Unemployment, youth total (% of total labor force ages 15-24)	...	10.5	10.5	...	...	10.2	...	...
<b>General indicators</b>								
Fertility rate, total (births per woman)	3.9	2.9	2.8	2.7	2.7	2.6	2.6	...
GNI per capita, Atlas method (current US\$)	390	620	810	1,050	1,170	1,290	1,450	1,530
GNI, Atlas method (current US\$) (billions)	341	698	941	1,229	1,393	1,559	1,766	1,890
Gross capital formation (% of GDP)	26.0	32.8	35.7	35.5	36.3	37.0	35.4	35.6
Life expectancy at birth, total (years)	58.4	63.0	63.7	64.4	64.8	65.1	65.5	...
Literacy rate, adult total (% of people ages 15 and above)	...	...	62.8	...	...	...	...	...
Population, total (millions)	874	1,120	1,160	1,175	1,190	1,206	1,221	1,237
Trade (% of GDP)	15.2	36.9	45.3	58.0	43.6	47.8	55.0	...

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

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

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

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

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

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

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

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

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

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

**Table 2. India: Selected Economic Indicators, 2009/10-2014/15 1/**

I. Social Indicators						
GDP (2012/13)		Poverty (percent of population)				
Nominal GDP (in billions of U.S. dollars):	1,842	Headcount ratio at \$1.25 a day (2010)		32.7		
GDP per capita (U.S. dollars):	1,489	Undernourished (2011):		17.5		
Population characteristics (2011/12)		Income distribution (2010, WDI)				
Total (in billions):	1.2	Richest 10 percent of households:		28.8		
Urban population (percent of total):	31	Poorest 20 percent of households:		8.5		
Life expectancy at birth (years):	65	Gini index (2005):		33.4		
II. Economic Indicators						
	2009/10	2010/11	2011/12	2012/13 Prel.	2013/14 Proj.	2014/15 Proj.
<b>Growth (in percent)</b>						
Real GDP (at factor cost)	8.6	9.3	6.2	5.0	4.6	5.4
Industrial production	5.3	8.2	2.9	1.1	...	...
<b>Prices (percent change, period average)</b>						
Wholesale prices (2004/05 w eights)	3.8	9.6	8.9	7.4	6.4	6.7
Wholesale prices (2004/05 w eights, end of period)	10.4	9.7	7.7	5.7	7.4	6.3
Consumer prices - industrial workers (2001 w eights)	12.4	10.4	8.4	10.4	10.5	8.6
<b>Saving and investment (percent of GDP)</b>						
Gross saving 2/	33.7	34.2	30.8	30.8	31.5	31.8
Gross investment 2/	36.5	36.8	35.0	35.6	34.8	34.9
<b>Fiscal position (percent of GDP) 3/</b>						
Central government deficit	-7.0	-6.4	-6.0	-5.1	-5.3	-5.6
General government deficit	-9.8	-8.4	-8.5	-7.8	-7.7	-8.0
General government debt 4/	72.5	67.4	67.0	67.6	67.3	67.3
Structural balance (% of potential GDP)	-9.5	-9.0	-9.1	-7.9	-7.5	-7.8
Structural primary balance (% of potential GDP)	-4.7	-4.4	-4.5	-3.3	-2.8	-2.8
<b>Money and credit (y/y percent change, end-period)</b>						
Broad money	16.9	16.1	13.2	13.8	13.6	14.7
Credit to commercial sector 5/	15.8	21.3	17.0	14.2	16.3	...
<b>Financial indicators (percent, end-period)</b>						
91-day treasury bill yield (end-period) 5/	4.4	7.3	9.0	8.2	8.6	...
10-year government bond yield (end-period) 5/	7.8	8.0	8.6	8.0	8.8	...
Stock market (y/y percent change, end-period)	80.5	10.9	-10.5	8.2	...	...
<b>External trade 6/</b>						
Merchandise exports (in billions of U.S. dollars)	182.4	250.5	309.8	306.6	319.4	340.6
(Annual percent change)	-3.5	37.3	23.7	-1.0	4.2	6.6
Merchandise imports (in billions of U.S. dollars)	300.6	381.1	499.5	502.2	497.4	523.2
(Annual percent change)	-2.6	26.7	31.1	0.5	-1.0	5.2
Terms of trade, goods (annual percent change)		-0.7	-2.5	-3.1	-1.7	...
<b>Balance of payments (in billions of U.S. dollars)</b>						
Current account balance	-38.2	-45.9	-78.2	-88.2	-61.6	-59.9
(In percent of GDP)	-2.8	-2.7	-4.2	-4.8	-3.3	-3.1
Foreign direct investment, net	18.0	9.4	22.1	19.8	23.1	25.0
Portfolio investment, net (equity and debt)	32.4	30.3	17.2	26.9	-5.0	19.8
Overall balance	13.0	12.9	-13.1	3.4	4.5	17.8
<b>External indicators</b>						
Gross reserves (in billions of U.S. dollars, end-period)	279.1	304.8	294.4	292.0	296.6	314.3
(In months of imports) 7/	7.2	6.3	6.1	6.0	5.8	5.7
External debt (in billions of U.S. dollars, end-period)	260.9	305.9	345.5	390.0	459.1	499.6
External debt (percent of GDP, end-period)	19.1	17.9	18.4	21.2	24.8	25.9
Of which: Short-term debt 8/	6.6	7.0	7.4	8.9	10.5	10.7
Ratio of gross reserves to short-term debt (end-period) 8/	3.1	2.6	2.1	1.8	1.5	1.5
Debt service ratio 9/	5.0	5.1	5.8	4.2	5.6	5.4
<b>Real effective exchange rate</b>						
(based on annual average level)	8.0	11.6	-3.4	-2.4	...	...
Exchange rate (rupee/U.S. dollar, end-period) 5/	45.5	45.0	50.3	54.4	61.7	...

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

1/ Data are for April–March fiscal years.

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

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

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

5/ For 2013/14, as of December 5, 2013.

6/ On balance of payments basis.

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

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

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

**Table 3. India: Balance of Payments, 2009/10-2014/15 1/**

(In billions of U.S. dollars)

	2009/10	2010/11	2011/12	2012/13 Prel.	2013/14 Proj.	2014/15 Proj.
Current account balance	-38.2	-45.9	-78.2	-88.2	-61.6	-59.9
Merchandise trade balance	-118.2	-130.6	-189.8	-195.7	-177.9	-182.6
Merchandise exports	182.4	250.5	309.8	306.6	319.4	340.6
Merchandise imports	300.6	381.1	499.5	502.2	497.4	523.2
Oil	87.1	106.0	155.0	168.5	176.0	182.7
Non-oil	213.5	275.1	344.6	333.8	321.3	340.6
Non-factor services balance	36.0	48.8	64.1	64.9	68.9	76.3
Receipts	96.0	132.9	142.3	145.7	154.9	170.0
<i>Of which</i> : software services	49.7	55.5	62.2	65.9	...	...
Payments	60.0	84.1	78.2	80.8	86.0	93.6
Income, net	-8.0	-17.3	-16.0	-21.5	-24.8	-27.9
Transfers, net	52.0	53.1	63.5	64.0	72.2	74.3
Capital account balance	51.6	62.0	67.8	89.3	65.1	77.6
Direct investment, net	18.0	9.4	22.1	19.8	23.1	25.0
Portfolio investment, net	32.4	30.3	17.2	26.9	-5.0	19.8
Government borrowing, net	2.9	4.9	2.3	1.0	3.5	3.2
Commercial borrowing, net	2.0	12.5	10.3	8.5	6.7	8.0
Short-term credit, net	7.6	11.0	6.7	21.7	19.9	13.1
NRI deposits, net	2.9	3.2	11.9	14.8	20.4	11.6
Other capital, net 2/	-14.1	-9.3	-2.7	-3.4	-3.6	-3.1
Errors and omissions	0.0	-3.0	-2.4	2.7	1.1	0.0
Overall balance	13.4	13.1	-12.8	3.8	4.5	17.7
Valuation changes 3/	13.6	12.7	2.4	-6.2	0.0	0.0
Increase in gross reserve stock (including valuation changes)	-27.1	-25.8	10.4	2.3	-4.5	-17.7
Memorandum items:						
Foreign exchange reserves	279.1	304.8	294.4	292.0	296.6	314.3
In months of next year's imports (goods and services)	7.2	6.3	6.1	6.0	5.8	5.7
Current account balance (percent of GDP)	-2.8	-2.7	-4.2	-4.8	-3.3	-3.1
Merchandise trade balance (percent of GDP)	-8.7	-7.6	-10.1	-10.6	-9.6	-9.5
Overall balance (percent of GDP)	1.0	0.8	-0.7	0.2	0.2	0.9

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

1/ Data are for April-March fiscal years.

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

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

**Table 4. India: Reserve Money and Monetary Survey, 2009/10-2013/14 1/**

	2009/10	2010/11	2011/12	2012/13	2013/14 October
<b>Reserve money</b> (In billions of rupees, end-period)					
Reserve money	11,557	13,768	14,263	15,149	15,793
Net domestic assets of RBI	-763	483	-459	-432	-1,115
Claims on government (net)	2,116	3,966	5,357	5,906	6,972
Center	2,116	3,940	5,344	5,905	6,951
States	0	25	13	1	21
Claims on commercial sector	13	22	40	31	38
Claims on banks	12	52	48	404	419
Other items (net)	-2,904	-3,556	-5,904	-6,772	-8,544
Net foreign assets of RBI	12,319	13,286	14,722	15,581	16,908
(Contribution to twelve-month reserve money growth)					
Reserve money	17.0	19.1	3.6	6.2	8.0
Net domestic assets of RBI	21.8	10.8	-6.8	0.2	-1.5
Claims on government (net)	15.2	16.0	10.1	3.8	9.7
Net foreign assets of RBI	-4.9	8.4	10.4	6.0	9.6
<b>Monetary survey</b> (In billions of rupees, end-period)					
Broad money (M3)	56,027	65,041	73,648	83,820	89,492
Currency with public	7,675	9,118	10,227	11,447	11,898
Deposits	48,314	55,886	63,394	72,340	77,559
Non-bank deposits at RBI	38	37	28	32	36
Net domestic assets	43,212	51,108	58,211	67,454	72,381
Domestic credit	51,606	62,206	73,301	83,719	89,819
Net credit to government	16,692	19,839	23,717	27,072	29,867
Of which: RBI	2,116	3,966	5,357	5,906	6,972
Credit to commercial sector	34,914	42,367	49,584	56,647	59,953
Of which: commercial bank lending	32,448	39,421	46,119	52,605	56,149
Nonfood	31,963	38,778	45,305	51,640	55,224
Other items (net)	-8,394	-11,098	-15,091	-16,265	-17,438
Net foreign assets	12,815	13,933	15,438	16,367	17,111
(Twelve-month percent change)					
Broad money (M3)	16.9	16.1	13.2	13.8	13.0
Net domestic assets	25.5	18.3	13.9	15.9	14.5
Domestic credit	20.2	20.5	17.8	14.2	14.7
Net credit to government	30.7	18.9	19.5	14.1	13.3
Credit to commercial sector	15.8	21.3	17.0	14.2	15.4
Of which: commercial bank lending	16.9	21.5	17.0	14.1	16.5
Nonfood	17.1	21.3	16.8	14.0	17.0
Net foreign assets	-5.2	8.7	10.8	6.0	7.2

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

1/ Data are for April–March fiscal years.

**Table 5. India: Central Government Operations, 2009/10-2014/15 1/**

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
				Est.	Proj.	Proj.
	(In percent of GDP)					
<b>Revenue</b>	<b>9.2</b>	<b>9.0</b>	<b>8.7</b>	<b>9.1</b>	<b>9.1</b>	<b>9.3</b>
Taxes	7.1	7.4	7.1	7.4	7.3	7.5
Income tax	5.8	5.7	5.5	5.5	5.8	5.9
Excise tax	1.6	1.8	1.6	1.8	1.5	1.5
Customs duties	1.3	1.7	1.7	1.7	1.5	1.5
Other taxes	0.0	0.0	0.0	0.1	0.0	0.0
Less: States' share	2.5	2.8	2.8	2.9	3.1	3.0
Grants	0.0	0.0	0.0	0.0	0.0	0.0
Other revenue 2/	2.0	1.6	1.6	1.6	1.8	1.8
Property income	1.1	0.9	0.8	0.7	0.8	0.8
Sale of goods and services	0.3	0.3	0.3	0.3	0.2	0.2
Miscellaneous and unidentified revenue	0.6	0.5	0.5	0.6	0.7	0.7
<b>Expenditure</b>	<b>16.1</b>	<b>15.4</b>	<b>14.8</b>	<b>14.2</b>	<b>14.3</b>	<b>14.9</b>
<b>Expense 3/</b>	<b>14.6</b>	<b>13.7</b>	<b>13.1</b>	<b>12.7</b>	<b>12.8</b>	<b>13.5</b>
Compensation of employees 4/	1.4	1.2	1.1	1.1	1.1	1.1
Interest	3.3	3.0	3.0	3.1	3.3	3.6
Subsidies 5/	2.2	2.1	2.4	2.5	2.1	2.3
Food	0.9	0.8	0.8	0.8	0.8	1.0
Fertilizer	0.9	0.8	0.8	0.7	0.6	0.5
Petroleum	0.4	0.5	0.8	1.0	0.7	0.8
Grants	2.2	1.9	2.0	1.9	2.1	2.1
Other expense 6/	5.4	5.5	4.7	4.1	4.3	4.4
<b>Net acquisition of nonfinancial assets</b>	<b>1.6</b>	<b>1.8</b>	<b>1.6</b>	<b>1.5</b>	<b>1.5</b>	<b>1.5</b>
Gross Operating Balance	-5.4	-4.6	-4.4	-3.6	-3.7	-4.2
<b>Net lending / borrowing (overall balance)</b>	<b>-7.0</b>	<b>-6.4</b>	<b>-6.0</b>	<b>-5.1</b>	<b>-5.3</b>	<b>-5.6</b>
Net financial transactions	-7.0	-6.4	-6.0	-5.1	-5.3	-5.6
Net acquisition of financial assets	-0.7	-1.8	-0.2	-0.3	-0.5	0.2
Domestic	-0.7	-1.8	-0.2	-0.3	-0.5	0.2
Currency and deposits	-0.5	-0.3	0.0	-0.1	-0.1	0.8
Loans	0.1	0.2	0.0	0.1	0.1	-0.1
Share and other equity	-0.4	-1.7	-0.2	-0.3	-0.5	-0.5
Net incurrence of liabilities	6.2	4.6	5.8	4.9	4.7	5.9
Domestic	6.1	4.3	5.7	4.8	4.6	5.8
Debt securities 7/	6.2	4.2	4.9	4.2	4.3	5.8
Other accounts payable	-0.1	0.1	0.8	0.6	0.3	0.0
Foreign	0.2	0.3	0.1	0.0	0.1	0.1
Loans	0.2	0.3	0.1	0.0	0.1	0.1
<b>Memorandum items:</b>						
Balance under authorities' definition	-6.5	-4.8	-5.7	-4.9	-4.8	-5.2
Primary balance	-3.7	-3.4	-3.0	-2.0	-2.0	-2.1
Central government debt 8/	56.3	52.1	51.8	51.9	51.4	51.2

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

1/ Data for April - March fiscal years

2/ In 2010/11 and subsequent years, auctions for wireless spectrum are classified as sale of nonfinancial assets.

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

4/ Pensions are included under expense not otherwise classified.

5/ Includes subsidy-related bond issuance.

6/ Other expense includes purchases of goods and services.

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

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

**Table 6. India: General Government Operations, 2009/10-2014/15 1/**

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
			Est.	Prov.	Proj.	Proj.
	(In percent of GDP)					
<b>Revenue</b>	<b>18.5</b>	<b>18.8</b>	<b>18.8</b>	<b>19.5</b>	<b>19.6</b>	<b>19.8</b>
Taxes	15.2	16.1	16.1	16.8	16.8	16.9
Grants	0.0	0.0	0.0	0.0	0.0	0.0
Other revenue	3.2	2.7	2.7	2.7	2.9	2.9
<b>Expenditure</b>	<b>28.3</b>	<b>27.2</b>	<b>27.3</b>	<b>27.3</b>	<b>27.3</b>	<b>27.8</b>
Expense	24.5	23.5	23.7	23.5	23.4	24.2
<i>of which:</i> interest	4.9	4.5	4.5	4.6	4.8	5.0
Net acquisition of nonfinancial assets	3.8	3.7	3.6	3.8	3.9	3.5
Gross Operating Balance	-6.0	-4.7	-4.9	-4.0	-3.8	-4.5
<b>Net lending (+)/borrowing (-) (fiscal balance)</b>	<b>-9.8</b>	<b>-8.4</b>	<b>-8.5</b>	<b>-7.8</b>	<b>-7.7</b>	<b>-8.0</b>
Net financial worth, transactions	-9.8	-8.4	-8.5	-7.8	-7.7	-8.0
Net acquisition of financial assets	0.0	-0.6	0.0	0.0	-0.3	0.2
Domestic	0.0	-0.6	0.0	0.0	-0.3	0.2
Currency and deposits	-0.1	0.2	0.0	-0.1	-0.1	0.8
Loans	0.5	0.8	0.2	0.3	0.3	-0.1
Equity and investment fund shares	-0.4	-1.7	-0.2	-0.3	-0.5	-0.5
Net incurrence of liabilities	<b>9.8</b>	<b>7.7</b>	<b>8.4</b>	<b>7.8</b>	<b>7.4</b>	<b>8.2</b>
Domestic	9.6	7.4	8.3	7.7	7.3	8.2
Debt securities	7.9	5.3	6.8	6.0	5.9	7.1
Other accounts payable	1.7	2.1	1.5	1.7	1.4	1.0
Foreign	0.2	0.3	0.1	0.0	0.1	0.1
Loans	0.2	0.3	0.1	0.0	0.1	0.1
<b>Memorandum items:</b>						
Primary balance	-4.8	-3.9	-4.0	-3.2	-2.9	-3.0
Nondefence capital expenditure	3.0	2.9	2.8	3.1	3.2	2.9
State and union territory governments' balance 2/	-2.8	-2.0	-2.0	-2.4	-2.4	-2.3
General government debt 3/	72.5	67.4	67.0	67.6	67.3	67.3

Sources: Data provided by the Indian authorities; state level data from the RBI Study on State Finances; and Fund staff amalgamate and prepare projections.

1/ The consolidated general government comprises the central government (CG) and state governments. Data for April-March fiscal year.

2/ The authorities treat states' divestment proceeds, including land sales, above-the-line as miscellaneous capital receipts. Staff definition treats divestment receipts as a below-the-line financing item.

3/ Includes combined domestic liabilities of CG and states governments, inclusive of MSS bonds, and sovereign external debt at year-end exchange rates.

Table 7. India: Macroeconomic Framework, 2009/10-2018/19 1/

	2009/10	2010/11	2011/12	2012/13	Prel.	Projections				
					2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
<b>Growth (percent change)</b>										
Real GDP (at factor cost)	8.6	9.3	6.2	5.0	4.6	5.4	6.4	6.5	6.7	6.7
Non-agricultural sector	10.1	9.6	6.6	5.5	4.6	5.6	6.8	7.0	7.2	7.2
<b>Prices (percent change, period average)</b>										
Wholesale prices (2004/05 =100)	3.8	9.6	8.9	7.4	6.4	6.7	5.6	5.4	5.3	5.2
Consumer prices	12.4	10.4	8.4	10.4	10.5	8.6	8.0	7.1	6.6	6.6
<b>Saving and investment (percent of GDP)</b>										
Gross saving 2/	33.7	34.2	30.8	30.8	31.5	31.8	32.0	32.3	32.6	33.0
Gross investment 3/	36.5	36.8	35.0	35.6	34.8	34.9	35.0	35.2	35.3	35.6
<b>Fiscal position (percent of GDP)</b>										
Central government balance 4/	-7.0	-6.4	-6.0	-5.1	-5.3	-5.6	-5.3	-5.2	-5.1	-5.1
General government balance 4/	-9.8	-8.4	-8.5	-7.8	-7.7	-8.0	-7.6	-7.4	-7.3	-7.1
General government debt 5/	72.5	67.4	67.0	67.6	67.3	67.3	66.3	65.3	64.6	63.9
<b>External trade (percent change, BOP basis)</b>										
Merchandise exports (in U.S. dollar terms)	-3.5	40.5	21.8	-2.1	4.2	6.6	6.7	6.7	6.7	7.2
Merchandise imports (in U.S. dollar terms)	-5.0	28.2	32.3	0.8	-1.0	5.2	7.0	7.0	7.0	7.5
<b>Balance of payments (in billions of U.S. dollars)</b>										
Current account balance	-38.2	-45.9	-78.2	-88.2	-61.6	-59.9	-62.8	-66.5	-67.9	-72.8
(in percent of GDP)	-2.8	-2.7	-4.2	-4.8	-3.3	-3.1	-3.0	-2.9	-2.7	-2.7
Foreign direct investment, net	18.0	9.4	22.1	19.8	23.1	25.0	27.3	29.9	32.7	35.6
Portfolio investment, net (equity and debt)	32.4	30.3	17.2	26.9	-5.0	19.8	25.9	28.3	30.9	33.7
Overall balance	13.4	13.1	-12.8	3.8	4.5	17.7	17.5	20.8	26.0	30.8
<b>External indicators</b>										
Gross reserves (in billions of U.S. dollars, end-period)	279.1	304.8	294.4	292.0	296.6	314.3	331.8	352.6	378.7	409.5
(in months of imports) 6/	7.2	6.3	6.1	6.0	5.8	5.7	5.6	5.5	5.5	5.5
External debt (in billions of U.S. dollars, end-period)	260.9	305.9	345.8	392.1	459.1	499.5	537.1	576.7	623.1	675.3
External debt (percent of GDP, end-period)	19.1	17.9	18.5	21.3	24.8	25.9	25.5	25.1	24.8	24.6
Of which : short-term debt 7/	6.6	7.0	7.4	8.9	10.6	10.7	10.7	10.5	10.6	10.8
Ratio of gross reserves to short-term debt (end-period) 7/	3.1	2.6	2.1	1.8	1.5	1.5	1.5	1.5	1.4	1.4
Debt service (percent of current account receipts)	5.0	5.1	5.8	4.2	5.6	5.4	5.4	5.6	5.8	5.7

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

1/ Data are for April-March fiscal years unless otherwise mentioned.

2/ Differs from official data, calculated with gross investment and current account.

3/ Statistical discrepancy adjusted.

4/ Divestment and license auction proceeds are treated as financing; includes subsidy related bond issuance.

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

6/ Imports of goods and services projected over the following twelve months.

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

**Table 8. India: Indicators of Financial System Soundness, 2005/06-2012/13**

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Measures of financial strength and performance 1/								
Risk-weighted capital adequacy ratio (CAR) 2/	12.3	12.3	13.0	13.2	13.6	14.2	14.2	13.8
Public sector banks	12.2	12.4	12.5	12.3	12.1	13.1	13.2	12.4
Old Private Sector Banks	11.7	12.1	14.1	14.3	13.8	14.6	14.1	13.7
New Private Sector Banks	12.6	12.0	14.4	15.1	17.3	16.9	16.7	17.5
Foreign banks	13.0	12.4	13.1	15.0	18.1	17.0	16.7	17.9
Number of institutions not meeting 9 percent CAR	3	0	0	0	1	0	0	0
Public sector banks	0	0	0	0	0	0	0	0
Old Private Sector Banks	3	1	0	0	1	0	0	0
New Private Sector Banks	0	0	0	0	0	0	0	0
Foreign banks	0	0	0	0	0	0	0	0
Net nonperforming loans (percent of outstanding net loans) 3/	1.2	1.0	1.1	1.1	1.1	1.1	1.4	1.7
Public sector banks	1.3	1.1	1.1	0.9	1.1	1.2	1.7	2.0
Old Private Sector Banks	1.7	1.0	0.7	0.9	0.8	0.5	0.6	0.8
New Private Sector Banks	0.8	1.0	1.4	1.4	1.1	0.6	0.5	0.4
Foreign banks	0.8	0.7	0.8	1.8	1.8	0.6	0.6	1.0
Gross nonperforming loans (percent of outstanding loans)	3.3	2.5	2.4	2.3	2.4	2.4	3.1	3.4
Public sector banks	3.6	2.7	2.3	2.0	2.2	2.3	3.3	4.1
Old Private Sector Banks	4.4	3.1	2.3	2.4	2.3	2.3	1.8	1.9
New Private Sector Banks	1.7	1.9	2.9	3.1	2.9	2.6	2.2	2.0
Foreign banks	1.9	1.8	1.9	3.8	4.3	2.5	2.6	2.9
Number of institutions with net NPLs above 10 percent of advances	3	1	0	0	1	0	0	0
Public sector banks	0	0	0	0	0	0	0	0
Old Private Sector Banks	0	0	0	0	0	0	0	0
New Private Sector Banks	0	0	0	0	0	0	0	0
Foreign banks	3	1	0	0	1	0	0	0
Net profit (+)/loss (-) of commercial banks 4/	0.9	0.9	1.0	1.0	1.1	1.1	1.1	1.0
Public sector banks	0.8	0.8	0.9	0.9	1.0	1.0	0.9	0.9
Old Private Sector Banks	0.6	0.7	1.0	1.0	1.0	1.1	1.2	1.2
New Private Sector Banks	1.0	0.9	1.0	1.1	1.4	1.5	1.6	1.6
Foreign banks	1.5	1.7	1.8	1.7	1.3	1.8	1.8	1.8
Balance sheet structure of all scheduled banks								
Loan/deposit ratio	70.1	73.5	74.6	73.9	73.6	76.5	78.6	76.5
Investment in government securities/deposit ratio	31.9	28.0	27.9	28.7	28.8	26.0	27.0	30.3
Lending to sensitive sectors (in percent of loans and advances)								
Real estate	17.2	18.8	18.4	17.5	16.6	16.6	15.7	15.9
Capital market	1.5	1.8	2.5	1.8	1.9	1.8	1.7	1.5
Commodities	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0

Source: Annual Report and Report On Trend and Progress of Banking in India, Financial Stability Report, Reserve Bank of India - Weekly Statistical Supplement; Bankscope.

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

2/ Until 2009/10 Based on Basel I; subsequently, Basel II is used. The Basel II CAR exceeded the Basel I CAR by 1.2 percent.

3/ Gross nonperforming loans less provisions.

4/ In percent of total assets.

**Table 9. India: Indicators of External Vulnerability, 2008/09–2012/13 1/**

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2/
<b>Financial indicators</b>							
General government debt (percent of GDP)	74.5	72.5	67.4	67.0	67.6	67.3	(Projection)
Broad money (percent change, 12-month basis)	19.3	16.9	16.1	13.2	13.8	13.6	(November 2013)
Private sector credit (percent change, 12-month basis)	16.9	15.8	21.3	17.0	14.2	12.8	(November 2013)
91 day T-bill yield (percent; end-period)	5.0	4.4	7.3	9.0	8.2	8.9	(November 2013)
91 day T-bill yield (real, percent; end-period) 3/	-4.1	-8.0	-3.1	0.6	-2.3	-2.5	(October 2013)
<b>External indicators</b>							
Exports (percent change, 12-month basis in US\$) 4/ 5/	13.7	-3.5	37.3	23.7	-1.0	4.2	(Projection)
Export volume (percent change, 12-month basis) 5/	7.1	-2.6	26.9	9.0	1.5	4.8	(Projection)
Imports (percent change, 12-month basis in US\$) 4/ 5/	19.8	-2.6	26.7	31.1	0.5	-1.0	(Projection)
Import volume (percent change, 12-month basis) 5/	7.6	6.7	15.0	8.1	1.8	2.0	(Projection)
Terms of trade (percent change, 12 month basis) 5/	-0.9	3.4	-3.3	-5.8	-0.5	2.0	(Projection)
Current account balance (percent of GDP)	-2.3	-2.8	-2.7	-4.2	-4.8	-3.3	(Projection)
Capital and financial account balance (percent of GDP)	0.6	3.7	3.6	3.6	4.8	3.5	(Projection)
<i>Of which</i> : Net portfolio investment (debt and equity)	-1.1	2.4	1.8	0.9	1.5	-0.3	(Projection)
Other investment (loans, trade credits, etc.)	-0.1	0.1	1.3	1.5	2.3	2.5	(Projection)
Net foreign direct investment	1.8	1.3	0.5	1.2	1.1	1.3	(Projection)
Foreign currency reserves (billions of US\$)	252.0	279.1	304.8	294.4	292.0	296.6	(Projection)
Official reserves (in months of imports of goods and services)	8.4	7.2	6.3	6.1	6.0	5.8	(Projection)
Ratio of foreign currency reserves to broad money (percent)	26.9	22.7	21.1	20.1	19.0	19.4	(October 2013)
Total short-term external debt to reserves (percent) 6/	32.4	32.5	39.2	47.2	56.3	65.8	(Projection)
Total external debt (percent of GDP)	18.4	19.1	17.9	18.4	21.2	24.8	(Projection)
<i>Of which</i> : public sector debt	4.8	4.5	3.9	3.6	3.7	3.9	(Projection)
Total external debt to exports of goods and services (percent)	76.1	93.7	79.8	76.4	86.2	96.8	(Projection)
External interest payments to exports of goods and services (percent)	2.9	2.3	1.9	2.3	0.0	1.7	(Projection)
External amortization payments to exports of goods and services (percent)	12.5	15.2	12.9	13.0	14.7	17.1	(Projection)
Exchange rate (per US\$, period average)	46.0	47.4	45.6	47.9	54.4	62.5	(November 2013)
REER (y/y change in percent; end-period)	-4.1	18.4	2.4	-3.8	3.0	-4.5	(November 2013)
<b>Financial market indicators</b>							
Stock market index (end-period)	9709	17528	19445	17404	18836	20792	(November 2013)
Foreign currency debt rating							
Moody's Investor Services	Baa2	Baa3	Baa3	Baa3	Baa3	Baa3	(November 2013)
Standard and Poor's 7/	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	(November 2013)
Fitch Ratings	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	(November 2013)

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

1/ Data for April-March fiscal years.

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

3/ Equals nominal yield minus actual CPIIW inflation.

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

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

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

7/ On negative outlook.

## Annex I. Key Measures Adopted in 2013/14<sup>1</sup>

### Monetary Policy

- **Changes in policy rates.** Cut in the repo rate by 25 bps to 7¼ percent in May, increase in the repo rate by 50 bps to 7¾ percent since July.
- **Liquidity measures.** Temporary liquidity window for banks to meet the cash requirements of mutual funds; reduction in the minimum daily maintenance of the CRR from 99% of the requirement to 95%; recalibrated bank access cap to the Liquidity Adjustment Facility to 0.5% of bank's net demand and time liabilities (NDTL); additional liquidity availed through 7- and 14-day term repos for an amount equivalent to 0.5% of banks' NTDL through variable rate auctions; RBI also announced plans to conduct open market operations of INR 80 bn.
- **Changes in Marginal Standing Facility (MSF).** Increase in the MSF rate by 200 bps to 10.25 percent in July, incrementally reduced to 8¾ percent.

### Financial Sector

- **Corporate bond market.** Short-term debt securities made eligible for trading. Credit default swaps allowed for unlisted rated-corporate bonds.
- **Non-performing assets.** Provisioning rate for restructured loans rose to 5% from 2.75%.
- **Risk management.** Exporters (importers) to cancel and rebook forward contracts to the extent of 50 (25) percent of the contracts booked in a financial year for hedging their contracted export (import) exposures.
- **Branch licensing.** Further liberalization of branch licensing in Tier 2 to Tier 6 cities.
- **Bank provisioning.** Incremental provisioning and capital requirements for lending to corporates with foreign currency exposures introduced.

### External Sector

- **Gold imports.** Import duty on gold was incrementally raised to 10% from 4%; restrictions introduced on nominated agencies and trading houses; restrictions on advances against gold coins introduced; at least 20% of every lot of gold import must be exclusively made available for export purposes; customs duty on gold and silver jewelry raised to 15%.
- **Remittances.** Existing limit on outward remittance scheme reduced from US\$200,000 to US\$75,000 per financial year.
- **FDI outflows.** Limit for overseas direct investment was reduced from 400% of the net worth to 100 percent under the automatic route. Measure was partly reversed on September 4.
- **Foreign institutional investors (FII) investment.** Increase in FII investment limits in government securities and corporate bonds by US\$5 billion each. Tax rate on interest income

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<sup>1</sup> Prepared by Sudip Mohapatra.

on government and corporate debt for foreigner investors reduced to 5% for a two-year period.

- **External commercial borrowing (ECB).** Increase in the infrastructure finance companies limit on overseas borrowing up to 75% of their owned funds (from 50%) and relaxation of foreign currency hedging requirement to 75% of the exposure (from 100%).
- **Overseas foreign currency borrowings.** Limits on bank borrowing from their head offices increased. RBI concessional rate USD-rupee swap facility (100 bps below market rate) for banks' overseas borrowings with 1 to 3 year tenors.
- **Swap window for new FCNR (B) deposits.** RBI US dollar-rupee swap window for fresh FCNR (B) dollar funds introduced for deposits of 3 years and above maturity.
- **Rupee export credit - interest subvention.** The rate of interest subvention on pre- and post-shipment rupee export credit for certain employment-oriented export sectors increased from 2% to 3%.
- **Oil swaps.** Foreign currency swaps offered to oil importing companies.

### Fiscal Policy

- **Food Security Act.** Parliament passed the National Food Security Bill which aims to provide two-thirds of the population with subsidized food grains.
- **Fuel subsidy.** Diesel prices partially deregulated. A hike of 50 paise a liter per month allowed for retail customers and nearly Rs 11 for bulk consumers.
- **Goods and Services Tax (GST).** The Ministry of Finance accepted almost all the recommendations of the Parliament Standing Committee on Finance.
- **Transaction tax.** Commodity Transaction Tax at 0.01% to be levied on futures trading of various non-agricultural commodities.
- **Expenditure cuts.** Government departments directed to cut non-plan expenditure by 10%.

### Structural Policy Actions

- **Cabinet Committee on Investment (CCI) clearances.** During 2013 the CCI cleared projects worth around 5 percent of GDP, primarily in power, mining, and oil exploration sectors.
- **Oil and gas sector.** The Ministry of Petroleum and Natural Gas has cleared investment projects worth US\$10-12 billion to develop oil and gas fields.
- **Companies Act.** Parliament passed the new Companies Act, strengthening accounting standards and shareholder rights, and mandating minimum corporate social responsibility outlays for large companies.
- **Pension Act.** Parliament passed the Pension Fund Regulatory and Development Authority Act, which would extend legal status to the pension regulator and increase foreign participation limit to 26%.
- **Land Acquisition Act.** Parliament passed the Right to Fair Compensation and Transparency in Land Acquisition Act.

## Annex II. India FSAP Main Recommendations and Risks: November 2013 Update<sup>1</sup>

Policy recommendations	Risks identified on mission
<b>Addressing system-wide risks</b>	<b>Action since 2013 Article IV Mission (Nov. 2012)</b>
<p>Enhance RBI monitoring of corporate indebtedness, refinancing risk, and foreign exchange exposures. (¶13 - FSSA)</p>	<p><b>Further risk reduction.</b> Banks were directed to check their corporate customers' unhedged FX-exposures and to provision more appropriately against risks emanating from those in line with formulas provided by the Reserve Bank of India (RBI), and to exchange information about them. Non-compliance can be penalized by supervisors. Although potentially significant implementation risk on this front still exists, this presents significant additional progress. Foreign exchange risk and high leverage can lead to more NPAs and stresses on the banking system.</p> <p>In order to get a comprehensive overview of the exposures of larger corporates, the RBI is setting up the "large borrowers database." Banks are supposed to provide each corporates exposure above certain thresholds. The data will inform the RBI about corporate exposures, but will be also shared with the banks. It is not clear how comprehensive it will be at this juncture, and what degree of the FX-exposures it will capture.</p>
<p>Improve the performance and financial strength of public financial institutions and subject them to full supervision and regulation. (¶20)</p>	<p><b>Further reduction of vulnerabilities and risks.</b> A law is being drafted to remove members of the boards of public banks who are related to supervisory agencies.</p> <p>Some of the public financial institutions are Non-Bank Financial Corporations (NBFCs), that aren't subject to RBI oversight. The RBI suggested that they be made subject to RBI oversight. No change in law is needed for that.</p> <p>It should be noted that the FSLRC will restructure India's financial supervisory system completely, including likely its greater centralization.</p>
<b>Financial sector oversight</b>	
<p>Strengthen oversight of banks' overseas operations through (MOUs) with host countries, onsite inspections, and supervisory colleges. (¶35)</p>	<p><b>Additional risk reduction.</b> Memorandums of Understandings are being negotiated and signed, in addition to the already signed ones (e.g., with Australia, Germany, UK).</p> <p>Overseas offices of Indian banks representing 86% of total overseas assets have been inspected so far.</p>
<p>Enhance formal statutory basis for the autonomy of regulators in carrying out their regulatory and supervisory functions. (¶35, 41, 46)</p>	<p><b>Additional risk reduction.</b> See point 2 above ("Further reduction of vulnerabilities and risks").</p> <p>The RBI notes that it currently cannot revoke the license of a Public Sector Bank, since they are organized as State Owned Enterprises, outside the companies' law. The RBI is asking the government to change that. This would necessitate a change in the relevant legislation.</p>

<sup>1</sup> Prepared by Peter Lindner (MCM).

Tighten the definition of large and related party concentration (short-term) and reduce exposure limits to align them with international practices. (¶135)	<b>No additional risk reduction.</b> The authorities feel that the current large group exposure limits that India employs, which are above the international norms, are needed in order to facilitate financing to such entities. They intend to adopt over time the large exposure limits that the Basel Committee for Banking Supervision will suggest in the future.
Enhance specialized expertise available to the supervision function by developing programs to accredit and retain skilled supervisors. (¶137)	<b>Some risk reduction is taking place.</b>  The RBI is working on setting up new certification systems. Also, a more structured and quantitative approach is being employed to training. New training programs are devised in cooperation with the World Bank's Financial Sector Development Program.  A particular challenge exists with regards to the training of NBFC supervisors, because of the variety of business models and issues that can arise in that area.
Continue to strengthen coordination and information sharing mechanisms among domestic supervisors via MOUs and formal frameworks (¶149, 67)	<b>Further reduction in risk.</b> A Financial Stability and Development Council was set up to facilitate coordination among the agencies. A subcommittee headed by the RBI Governor was also set up. Additional focus will be given to inter-regulatory financial reform efforts.  Regulators are also working together across agencies now on specific cases, when they span the purview of more than one agency.  The supervision of commodities exchanges was shifted to the Ministry of Finance from the Ministry of Corporate Affairs, in order to make supervision more comprehensive, and avoid regulatory arbitrage
Provide a lead supervisor with legal backing for conducting consolidated supervision with authority to inspect subsidiaries and affiliates. (¶149)	<b>Additional risk reduction.</b> The proposed addition to the banking law that allows banking supervisors to inspect companies associated with any bank went through parliament.
Expedite passage of Insurance Law (Amendment) Bill. (¶143)	<b>Not passed yet.</b>
Implement corrective action ladder for insurers (¶145)	<b>No change.</b>
Enact legislation formalizing the New Pension Scheme and the Pension Fund Regulatory and Development Authority. (¶133)	<b>Significant risk reduction.</b> The new pension law (PFRD) was passed.
Plan for the reduction in the Statutory Liquidity Ratio (SLR) and review the use of the hold-to-maturity category, incorporating changing global liquidity requirements. (¶151)	<b>No change.</b> Allowing banks to value an increased share of Government securities (Gsec) holdings above the SLR using the Held-to-Maturity approach, as was done recently, effectively will bias their holdings towards GSecs again.

Strengthen resolution tools by granting stronger powers to supervisors to resolve nonviable entities in an orderly fashion. (¶153)	<p><b>Some risk reduction.</b> Work on this is in the planning stage. An internal committee is looking into this matter, while a group under the FSLRC has been set up to work on an interagency basis. The RBI Governor has made this issue a priority. Vulnerabilities therefore still persist as of now.</p> <p>No procedures are under consideration for NBFCs.</p>
Develop and periodically test arrangements to deal with a major disruption to the financial system. (¶154, 66)	<p><b>Some risk reduction.</b> Work on this is generally in the planning stage. Vulnerabilities therefore persist.</p> <p>Crisis arrangements for the payments system have been tested.</p>
<b>Broadening markets and services</b>	
Ease investment directives and limits to encourage investments in corporate and infrastructure bonds by institutional investors. (¶134, 62)	<p><b>Additional measures implemented.</b> Taxes on FX-bonded debt were reduced, three types of investment limits for foreign investors were consolidated into one of \$51 billion, and new infrastructure investment schemes were implemented, one focused on foreigners.</p> <p>New guidelines were issued for insurers and pension funds, which should increase their participation in those markets.</p>
Consider further easing of restrictions on bond market investments by foreign institutional investors (FIIs). (¶159)	<p><b>Some progress.</b> Limits on Foreign Institutional Investors' investments in GSecs and Tbills together were combined into one, and increased to \$30 billion.</p>
<b>Financial markets infrastructure</b>	
Require Centralized Counterparty Clearing Houses to strengthen their liquidity risk management procedures to enable them to better cover losses in the event of a member's failure. (¶166)	<p><b>Notable risk reduction.</b> Emergency credit lines of \$3 billion were made available to Central Counterparty Clearing Houses, and up to \$10 billion in settlement lines.</p>
Consider replacing the commercial bank settlement model for corporate securities and derivatives with a central bank settlement model. (¶166)	<p><b>Some progress.</b> A committee of SEBI and the RBI is working on this issue.</p>
Enact comprehensive modern corporate insolvency law and upgrade SARFAESI and other existing laws governing insolvencies. (¶169)	<p><b>Partial progress.</b> New insolvency statutes have been passed as part of the new Companies Law. Its passing would likely be beneficial for the insolvency process, decreasing uncertainty and increasing credit availability particularly for small- and medium-sized enterprises.</p>

### Annex III. India: Risk Assessment Matrix

Nature/Source of Threat	Likelihood	Impact	Policies to Minimize Impact
<b>Domestic Risks</b>			
<b>Continued high inflation</b>	<b>H</b>	<b>M-H:</b> High inflation could weaken trust in economic management, depressing investment and financial savings and higher current account deficit. It also hurts the poor, especially in urban areas, the most. High inflation expectations could increase the economic costs of bringing inflation down in a sustainable way, further damaging growth.	Raising interest rates until inflation is clearly on a downward trend. Improved agricultural productivity and investing in infrastructure to improve the supply response can reduce food price pressures.
<b>Uncertainty regarding structural reforms continues to slow investment</b>	<b>M-H</b>	<b>H:</b> Growth will fall further, worsening tax revenues, add to corporate vulnerabilities and bank NPAs. Failure to increase the economy's capacity would exacerbate inflation and the current account deficit.	Further measures to ease supply bottlenecks, reduce policy uncertainty, facilitate inward investment, and improve the business climate and governance.
<b>Countercyclical fiscal expansion</b>	<b>M</b>	<b>M:</b> The captive investor base for government bonds lowers financing risks. Crowding out could hurt investment, and given little spare capacity, inflation and the current account deficit would rise. Continued slow fiscal consolidation would depress sentiment and increase India's vulnerabilities.	Fiscal consolidation and subsidy reform (protecting the poor) must be undertaken. Spending reorientation will make consolidation more growth-friendly. Measures should be taken to raise tax-to-GDP ratio to pre-crisis levels.
<b>Balance sheet risks</b>	<b>M</b>	<b>H:</b> Continued corporate stress could add to bank NPAs, raising capital concerns and reducing lending in the medium term.	Strengthened oversight of financial and corporate risks. Raising provisioning requirements. Policies to incentivize genuine corporate restructuring and improvements to insolvency framework.
<b>External Risks</b>			
<b>Protracted economic and financial volatility especially for EMs (UMP exit)</b>	<b>H</b>	<b>H:</b> As in 2008/09 and in recent months, financial stresses would be severe, given domestic and external vulnerabilities and weak balance sheets.	Focus on further capital account liberalization, in particular FDI. Continued interregulatory coordination and monitoring of financial conditions and risks. Rupee flexibility would absorb some of the shock, and monetary policy should be tightened.
<b>Protracted period of slower European growth</b>	<b>H</b>	<b>M-H:</b> Deterioration in the European economic outlook would further cloud the prospects for recovery in India, both for exports and investment.	Structural reform will raise returns to investment and strengthen domestic sources of growth.
<b>Sharp slowdown in growth in China</b>	<b>M</b>	<b>L:</b> Decline in commodity prices, weaker global growth and market sentiment toward EMs. Mixed effects on current account deficit, but lower inflation, investment and growth.	Structural reform and inward-oriented policies to enhance India's growth potential.
<b>Global oil shock (US\$150 per barrel)</b>	<b>L</b>	<b>M-H:</b> Significant effects on the current account deficit, inflation, and, if subsidies remain unreformed, the fiscal deficit.	Shift toward market pricing to minimize fiscal impact and improved targeting of transfers to shelter the most vulnerable.
<p>"L"=Low; "M"=Medium; "H"=High.</p> <p>This matrix shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The Risk Assessment Matrix reflects staff views on the source of risks and overall level of concern as of the time of discussions with authorities.</p>			

## Annex IV. Policy Responses of Emerging Markets (EMs) to Talk of Tapering<sup>1</sup>

The policy responses among EM countries to the Federal Reserve's Unconventional Monetary Policy (UMP) taper talk in May have varied, reflecting different fundamentals and policy space (Table 1).<sup>2</sup> Some have deployed a comprehensive package of policy actions, spanning fiscal, monetary and structural policy actions, while others (particularly South Africa) have relied solely on the exchange rate as the main shock absorber. This Annex compares the key components of India's policy response with that of other major EMs.

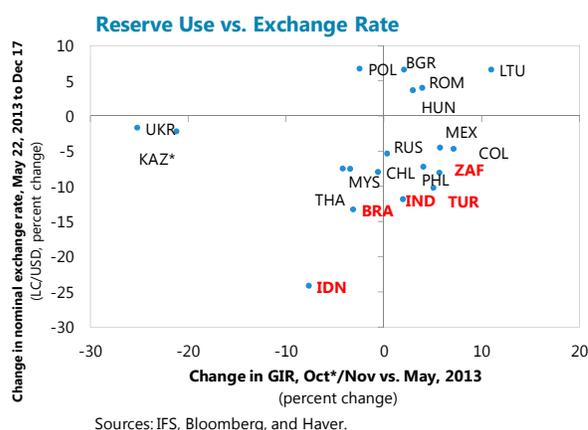
Table 1. Summary of Main Policy Responses in Selected Emerging Market Economies

	Brazil	Hungary	India	Indonesia	Mexico	Russia	South Africa	Turkey
Exchange rate flexibility	✓	✓	✓	✓	✓	✓	✓	✓
FX market intervention	✓		✓	✓		✓		✓
Monetary policy (tighten +/-loosen -)	✓(+)	✓(-)	✓(+)	✓(+)	✓ (-)			✓(+)
Capital flow measures	✓		✓	✓				
Import restrictions			✓					
Fiscal measures			✓					
Contingency financing			✓	✓				

### Exchange rate policy and foreign exchange market operations

Across the EMs, exchange rates were allowed to absorb the brunt of post-May market pressures. Several countries conducted foreign exchange intervention to smooth exchange rate volatility, and the modalities of that use of FX reserves varied greatly.

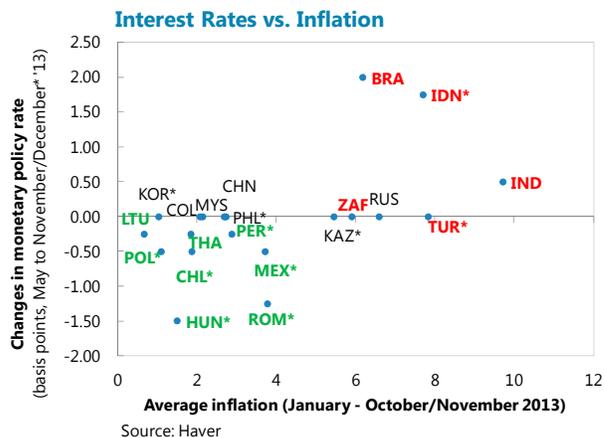
- **Brazil** pre-announced a program of daily auctions of FX swaps and repos from August 22 through year-end, with a cumulative amount equivalent to US\$51 billion. The program helped strengthen the *real* initially, although in recent months the currency has again weakened. In December the Central Bank of Brazil (BCB) extended the swaps auction until end-June 2014.



<sup>1</sup> Prepared by Ran Bi (SPR).

<sup>2</sup> This Annex focuses on major EMs (top 10 in terms of nominal GDP levels) whose currencies depreciated by more than 5 percent and 10-year government bond yields increased by more than 1 percent from May to August 2013. While Hungary was not hit as much, it is added here so that the Annex has sufficient coverage of major European EMs.

- **Indonesia** initially used a mix of spot intervention (with part of it directed toward meeting the FX needs of large oil and gas state-owned-enterprises), and moral suasion to limit the rupiah's depreciation but this led to sizeable reserve losses. Since July, Bank Indonesia (BI) has scaled back its intervention and allowed the rupiah to adjust to market conditions. In July, BI initiated biweekly auctions of FX swaps with resident banks, and in August, BI began allowing derivative positions held by banks to be passed on to BI through the swap auctions, extended the maturities of U.S. dollar term deposits offered by BI, and relaxed the rules on FX purchases by exporters to encourage repatriation.



- **India** initially conducted limited intervention in the spot market, but mostly allowed the rupee to depreciate. In August, the Reserve Bank of India (RBI) began providing its FX reserves directly to oil marketing companies (OMCs) through swap arrangements (at the market exchange rate). In addition, the central bank offered subsidized FX swaps to banks to attract non-resident Indian foreign currency (FCNR(B)) deposits and increase banks' overseas FX borrowing. The oil swaps and the FCNR(B) scheme both closed by end-November, and the OMCs returned to the FX market. The total volume of swaps with OMCs and banks amounted to about US\$10 billion and US\$34 billion (mainly from FCNR(B) deposits), respectively.
- **Russia** allowed increasing flexibility in the ruble, which depreciated by 6 percent in May/June 2013, the highest among emerging European countries, prompting some modest interventions by the Central Bank of the Russian Federation (CBR) utilizing an exchange rate band mechanism to limit short-term fluctuations.
- **Turkey** intervened significantly through the spot market by about US\$18 billion by end-2013 (representing more than 15 percent of net international reserves).

### Monetary policy and liquidity management

**Policy rate movements.** Facing inflationary pressures exacerbated by a depreciating currency led many EMs to raise policy rates. **Brazil** increased the policy rate by 275 basis points (bps) since the start of its tightening cycle in April 2013, **India** has had more moderate hikes of 50 bps in its repo rate, while **Indonesia** has raised its policy rate by 150 bps since end-May. However, others facing lower inflationary pressures reduced policy rates to offset the tightening of global financial conditions (**Mexico**) or to support weak domestic activity (**Hungary**).

**Liquidity measures.** Rather than rely on higher policy rates to protect the currency, some countries also raised short-term market interest rates through a range of other measures. The RBI in **India** raised the marginal standing facility (MSF) rate—the upper ceiling of the interest rate corridor—by 200 bps and capped liquidity provision at the repo rate (subsequently reversing these measures as markets stabilized). **Indonesia** increased the overnight deposit facility rate (i.e. the rate at which the central bank provides liquidity) by a total 150 bps. **Turkey** lifted the top end of its interest rate corridor by 125 bps, but left the main policy rate untouched. The Central Bank of the Republic of Turkey (CBRT) also suspended liquidity provision at the policy rate during designated exceptional days, resulting in an average increase of about 350 basis points in interbank rates by end-2013. **Hungary**, on the other hand, did not face as much external pressures and chose to further ease

monetary conditions by launching a scheme in April 2013 (to be operational in June-August 2013) to alleviate financing constraints of small and medium enterprises. The scheme was then extended to end-2014 with an increased funding allocation.

### Capital flow measures (CFMs)

**CFMs have been used to a limited extent.** *Brazil* eased CFMs significantly, reducing the tax rate to zero on fixed income (foreign portfolio investment) and short FX derivative positions in June 2013. *India* liberalized restrictions on external commercial borrowing and FDI. However, the government also tightened restrictions on some capital outflows from residents (although subsequently partially reversed this measure). *Indonesia* relaxed regulations on banks' short-term foreign borrowing and shortened the minimum holding period for central bank bills to attract foreign investors.

### Import restrictions

*India* hiked the gold import duty and imposed quantity restrictions on gold imports.

### Fiscal measures

*India* introduced expenditure rationalization policies and *Indonesia*, as planned prior to the tapering talk, increased subsidized fuel prices, among other measures. Brazil, India, Indonesia and Turkey all reiterated their commitment to meeting their fiscal targets.

### Contingency financing

**Several countries made arrangements for contingency financing.** *India* increased its swap line with Japan to US\$50 billion (from US\$15 billion). Also, the International Finance Corporation (IFC) launched a US\$1 billion offshore rupee bond program, with a first issuance of around \$160 million in November. *Indonesia* renewed its swap arrangement with Japan (US\$12 billion) in August and further increased its size (to US\$22.8 billion) in December. It also agreed on new swap arrangements with China (Yuan 100 billion) and Korea (US\$10 billion). *Mexico* renewed its Flexible Credit Lines with the Fund in December 2012.

### Summary: Indian policy response

**In sum, India responded in a manner similar to that of other EMs affected by UMP tapering,** deploying a broader range of policy measures, but the initial communication of the policy intent and composition of these measures could have been better explained to market participants. In particular, the repo rate could have been raised sooner to complement India's use of liquidity tightening measures. Nonetheless, India's limited intervention in foreign exchange markets, and continued rupee flexibility, have served the country well in responding to global financial market shocks.

**The FX swaps made available to OMCs and banks have proved effective at relatively low cost.** By temporarily removing a significant source of FX demand (which is also highly volatile) from the foreign exchange market, the swaps to OMCs limited volatility and halted self-fulfilling momentum in the exchange rate. The swaps involved no loss in gross international reserves, and the resulting forward position is limited and fully disclosed. The FCNR(B) deposit scheme attracted a significant amount of stable inflows (with maturities between 3-5 years) in just three months, and the subsidy is relatively limited (3–3½ percent below market rate). If external pressures re-emerge, these FX swaps could be deployed again, but the resulting forward position should be carefully monitored.

## Annex V. India's External Sector Assessment<sup>1</sup>

*The staff assess that India's current account deficit is slightly above a range of estimates for its medium-term norm and the exchange rate is slightly above levels that can be explained by underlying fundamentals. Compared to its trading partners, India's demographic structure, low per capita income, favorable growth prospects and large developmental needs justify running current account deficits. However, these pro-deficit factors need to be balanced by consideration of both sustainability and financing vulnerability risks, which tend to limit the size of the desirable deficit. Options to reduce the savings-investment imbalance include lowering inflation expectations to support private savings in financial assets rather than gold, slowing the rate of growth of public consumption, structural reforms, and further developing financial markets.*

### Current Account and Exchange Rates

- 1. The current account deficit widened to a historical high of 4.8 percent of GDP in 2012/13, mainly due to a rising trade deficit** (Figure 1). After a period of strong performance, exports decelerated sharply from late 2011 (in response to a lower global demand as well as binding supply constraints), while imports have slowed only moderately on account of continued fuel subsidies, inelastic demand for imported oil, high inflation expectations, and import-encouraging supply bottlenecks. In particular, gold imports (which are used partly as an inflation hedge) rose significantly (see Selected Issues Chapter I).
- 2. The real effective exchange rate has shown much short-term (within-year) volatility over the last several years, while the commodity terms of trade has deteriorated moderately.** The NEER depreciated by about 30 percent in the last decade while the REER appreciated by about 10 percent during the same period, reflecting the large inflation differential between India and its trading partners. The deterioration in commodity terms of trade (including oil, gold, and agricultural products) could have important implications for the current account and REER, given the structural increase in energy intensity of India, higher gold imports in recent years, and the inflationary effects of higher food prices.<sup>2</sup>
- 3. The observed worsening of the current account balance following the global financial crisis largely reflects a faster drop in national savings than in investment** (Figure 1). Since the late 1990s there has been a sharp increase in both savings and investment rates (consistent with an improvement in growth), but the widening current account deficit in the last few years primarily reflects a faster fall in national savings than investment as high inflation and negative real interest rates caused a shift away from savings in financial assets toward investment in valuables. Despite that, average private and public savings and investment are still relatively high in India compared with other emerging market economies and advanced countries.

<sup>1</sup> Prepared by Mehdi Raissi.

<sup>2</sup> See Cavalcanti, T., Mohaddes, K. and M. Raissi, 2012, "Commodity Price Volatility and the Sources of Growth", *IMF Working Paper* No. 12/12, (Washington: International Monetary Fund) for a discussion of commodity terms of trade.

## Model-based Current Account and Exchange Rate Valuations

### 4. This section assesses the magnitude of the current account gap and REER misalignment in India using External Balance Assessment (EBA) and Consultative Group on the Exchange Rate (CGER)-type methodologies.

- *The External Balance Assessment (EBA)* comprises three different methods for assessing the cyclically-adjusted current account and exchange rate compared to medium-term fundamentals and appropriate policies.<sup>3</sup> The current account regression estimates the cyclically-adjusted current account norm and compares it to a structural current account deficit (CAD) in 2013. The second method is based on a RER regression, which derives the deviation of the REER from its estimated equilibrium level, based on a set of fundamentals. The third method is the External Sustainability approach, which computes the current account balance that stabilizes the net foreign asset (NFA) position and compares it to the underlying CAD to measure the gap.
- *The CGER-type methodologies*<sup>4</sup> use an external sustainability (ES) approach and a macroeconomic balance (MB) method from Beidas-Strom and Cashin (2011). The ES and MB methodologies focus on current account misalignments and the required exchange rate adjustments that will ensure consistency between the underlying current accounts and the associated norms in the medium-term.

### 5. Model-based estimates suggest that India's current account deficit is above a range of estimates for its medium-term norm, and the exchange rate is slightly above levels that can be explained by underlying fundamentals. These estimates are presented in the table below.

- **The EBA methodologies.** Based on data available as of November 2013, the *current account regression* estimates India's cyclically-adjusted current account norm (i.e. the current account compatible with fundamentals and desired policies) to be -4.0 percent of GDP. The projected 2013 CAD of 3.3 percent of GDP corresponds to a structural CAD of 2.6 percent of GDP, implying a gap of 1.4 percent of GDP compared to the norm. The cyclically-adjusted CAD is much lower than the actual CAD as the output gap is small relative to the rest of the world's output gap and the terms-of-trade gap is large. These results suggest that the 2013-year-average real effective exchange rate is undervalued by 8 percent. The *RER regression* suggests that India's REER is overvalued by about 3 percent. According to the *ES approach*, India's current account norm is -1.6 percent of GDP, which is smaller than the staff's CAD projection for 2018 (the outer year of

<sup>3</sup> See the 2013 Pilot External Sector Report ([www.imf.org](http://www.imf.org)) for a discussion of EBA methodologies.

<sup>4</sup> See Lee, J., G. M. Milesi-Ferretti, J. Ostry, A. Prati, and L. Ricci, 2008, *Exchange Rate Assessments: CGER Methodologies*, IMF Occasional Paper No. 08/261, (Washington: International Monetary Fund); Vitek, F., 2009, "Exchange Rate Assessment Tools for Advanced, Emerging, and Developing Economies (Washington: International Monetary Fund); Beidas-Strom, S. and P. Cashin, 2011, "Are Middle Eastern Current Account Imbalances Excessive?" IMF Working Paper 11/195, (Washington: International Monetary Fund); and Chen, S., Dwight, L., Maechler, A., Nkusu, M., Raissi, M., Ter-Martirosyan, A., Vitek, F., and A. Watson, 2013, "External Assessments in Special Cases", Strategy Policy and Review Departmental Paper, (Washington: International Monetary Fund) for details about the CGER-type methodologies.

the medium-term horizon when output gaps are generally assumed to be closed), resulting in a gap of -1.1 percent of GDP and a real exchange rate overvaluation of about 6 percent.

- **The CGER-type methodologies.** The macrobalance approach by Beidas-Strom and Cashin (2011) suggests a current account norm of -2.6 percent of GDP (using the fiscal balance consistent with the desired fiscal position), about 0.2 percentage points lower than the underlying current account in the medium-term (-2.8 percent of GDP). Based on an elasticity of the CAD to the real effective exchange rate of -0.17 (as referenced by Vitek (2009)), this would imply an exchange rate misalignment of about 1 percent. The external sustainability approach estimates a current account norm for India which stabilizes the NFA/GDP of the country around its norm (estimated from a panel data model). Comparing this current account norm (-1.9 percent of GDP) with its underlying value (-2.8 percent of GDP), while using above elasticity, implies a REER overvaluation of about 5.4 percent.

**Current Account and REER Gaps 1/**

	EBA Methodologies (2013) 2/			CGER Methodologies (2018) 3/	
	CA Regression	RER Regression	External Sustainability	MB (Beidas-Strom and Cashin) 4/	External Sustainability
CA Norm (%GDP)	-4.0		-1.6	-2.6	-1.9
CA Gap (%GDP)	1.4		-1.1	-0.2	-0.9
Exchange rate gap	-7.8	3	6.1	1.2	5.4
<i>Memorandum items (percent of GDP, unless otherwise noted):</i>					
Actual CA/Y (2013)					-3.3
Cyclically Adjusted CA/Y (2013)					-2.6
Medium term CA/Y (2018)					-2.8

1/ For exchange rate gap, positive value indicates overvaluation. The estimated gaps are adjusted to impose a multilateral consistency.

2/ The gap under the CA regression of EBA is relative to its cyclically adjusted value.

3/ The macroeconomic balance (MB) approach is based on Beidas-Strom and Cashin (2011). It calculates the difference between the medium term CA balance (year 2018) and an estimated equilibrium CA "norm". The latter is a function of various fundamentals (fiscal balance, old-age dependency ratio, NFA, oil balance, real GDP per capita, real GDP growth, aid, and remittances). The ES approach is based on Vitek (2009) and calculates the difference between the actual CA balance in 2018 and the NFA-stabilizing CA balance. The real exchange rate adjustment is calculated to bring the current account balance in line with its NFA-stabilizing level.

**6. Model-based estimates suggest norms for the medium-term current account deficit ranging between 1½ and 4 percent of GDP** (see table). However, in staff's judgment, the EBA-estimated CAD norm of 4 percent of GDP is larger than can be sustainably financed given the implications for gross financing needs. Such a large CAD would imply a steady weakening of the NFA position, calling into question whether global financial markets would be willing to sustainably finance such a large deficit. Given the potential risks associated with global financial market volatility (as evidenced by events post 22 May, 2013), staff judges that a CA norm closer to the EBA-based ES approach or the CGER-like methodologies would be more appropriate, implying a modest

overvaluation of the real exchange rate.<sup>5</sup> This result is also comparable to the Reserve Bank of India's finding that India's sustainably-financed current account deficit is around 2.5 percent of GDP.<sup>6</sup>

### Capital Account Flows, International Reserves and International Investment Position

**7. India's financial account has been dominated by portfolio equity and FDI flows** (Figure 2). However, the composition of the current account deficit financing has shifted toward more debt flows and away from FDI recently. In 2012, FDI inflows only financed a quarter of the current account deficit, while they generally exceeded the CAD before 2007/08. Debt flows, particularly in the form of non-resident Indian (NRI) deposits and trade credits, have increased. Similarly, external commercial borrowings (by Indian corporates) have increased significantly since 2008. Net portfolio flows have been very volatile in the past and more recently in response to global financial market volatility.

**8. India's net foreign asset (NFA) position and its composition have deteriorated.** While both assets and liabilities have risen steadily over the last decade, external debt has increased sharply in the last three years (and is concentrated among the corporate sector). However, external debt at 23.8 percent of GDP at end-September 2013 remains moderate compared to other emerging market economies.

**9. Central bank intervention has focused on seeking to reduce the pace and volatility of exchange rate changes** (Figure 1). The authorities are committed to a market-determined exchange rate and have recently undertaken FX intervention through FX swap facilities for oil importers and NRI deposits. However, with the widening of the CAD and exchange rate interventions, international reserve coverage has fallen since mid-2011 (Figure 2). International reserves have stabilized at around US\$296 billion, a level which is more than adequate as measured by various metrics, including the IMF's composite reserve adequacy measure. Specifically, international reserves in India stand at around 5¾ months of imports, and 145 percent of the IMF's composite metric. As such, India is well placed to withstand external shocks.

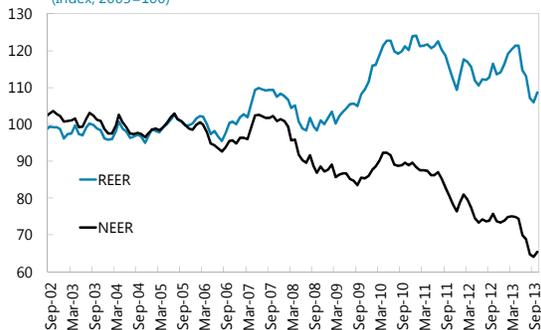
<sup>5</sup> The May 2013 External Sector Report concluded that India's current account and the value of rupee were broadly in line with fundamentals.

<sup>6</sup> See Goyal, R., 2012, "Sustainable Level of India's Current Account Deficit," RBI Working Paper 16/2012; Mishra, P. and C. Rangarajan, 2013, "India's External Sector: Do We Need to Worry?," Economic and Political Weekly, No. 48.; and Callen, T. and P. Cashin, 1999, "Assessing External Sustainability in India", IMF Working Paper 99/181, (Washington: International Monetary Fund) and *Journal of International Trade and Economic Development*, Vol. 11, pp. 77–98. Goyal (2012) and Callen and Cashin (1999) provide model-based discussions of external sustainability concerns.

### Annex V. Figure 1. Current Account and Exchange Rate Developments

#### Nominal and Real Effective Exchange Rates

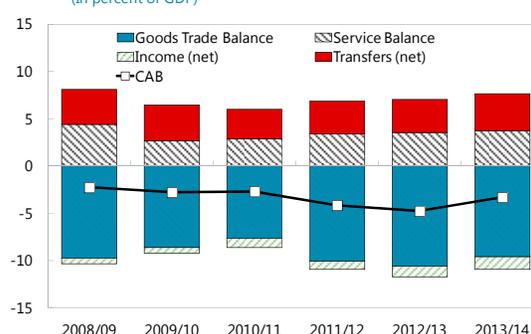
(Index, 2005=100)



Sources: IMF, Information Notice System and IMF staff estimates.

#### Current Account Flows

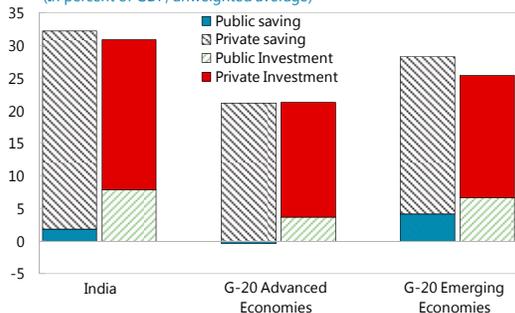
(In percent of GDP)



Sources: CEIC, INS, and IMF staff calculations.

#### India and the G-20: Saving and Investment, 2008-2012

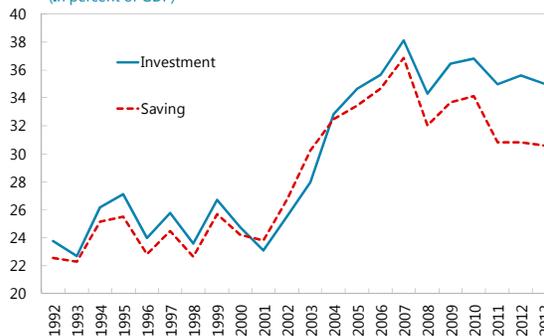
(In percent of GDP, unweighted average)



Source: IMF, World Economic Outlook.

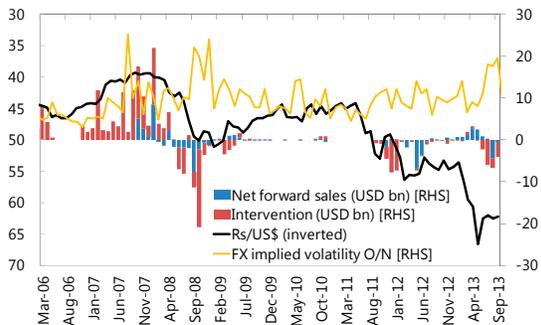
#### Investment & Savings

(In percent of GDP)



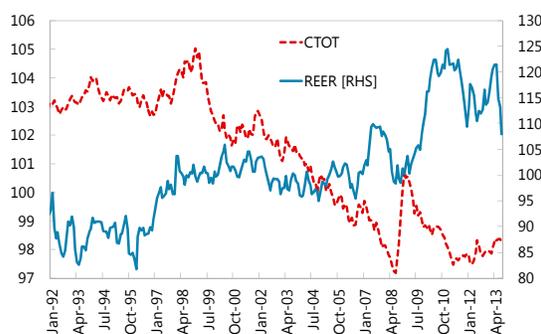
Sources: IMF, World Economic Outlook.

#### Exchange Rate and Intervention



Sources: CEIC; Bloomberg; and IMF staff calculations

#### Commodity Terms of Trade and REER

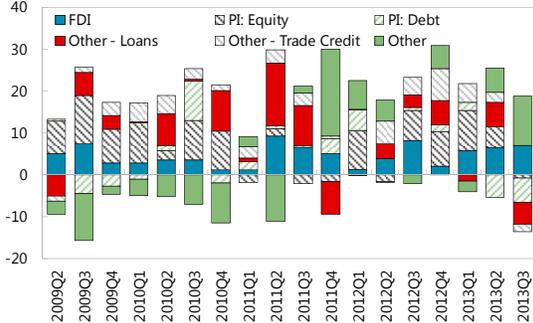


Source: Cavalcanti, Mohaddes, and Raissi (2011).

### Annex V. Figure 2. Capital Flows and Net Investment Position

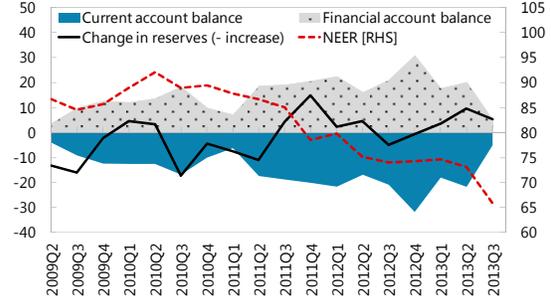
#### Net Capital Flows

(In billions of USD)



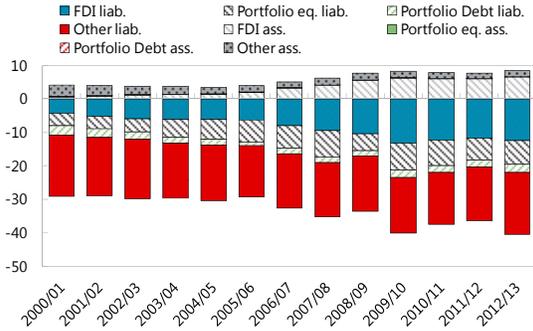
#### Balance of Payments, Reserve Accumulation, and NEER

(In billions of USD)



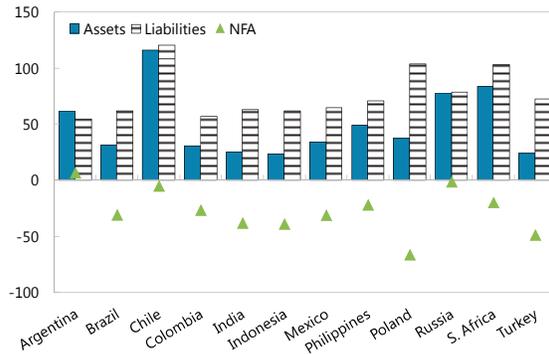
#### International Investment Position

(In percent of GDP)



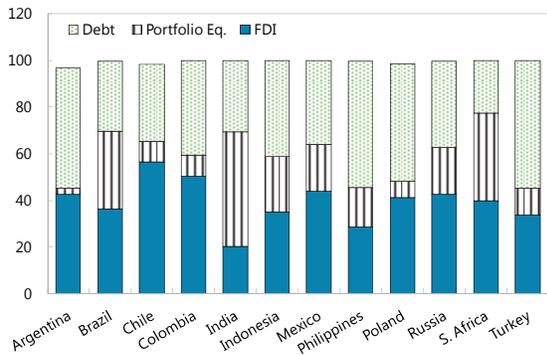
#### International Investment Position, 2010

(In percent of GDP)



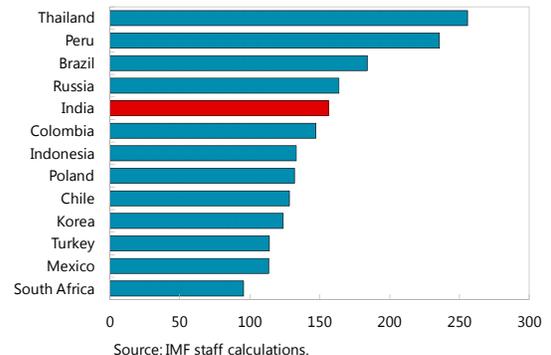
#### Composition of Liabilities, 2010

(In percent of total liabilities)



#### Gross International Reserves, 2012

(As a percent of IMF Reserves Adequacy Metric)



## Annex VI. India: Public and External Debt Sustainability Analysis<sup>1</sup>

India's public debt remains sustainable given manageable interest rate costs and expected recovery in the economy's growth rate.<sup>2</sup> Under the baseline, the public debt-to-GDP ratio is forecast to decline gradually to about 64 percent of GDP in the medium term from the current level of 68 percent, with gross financing needs also reducing slightly to about 12 percent of GDP in 2018/19. While the baseline scenario already uses conservative real GDP assumptions, further negative growth shocks represent one of the major risks to the debt outlook. In addition to this, realization of contingent liabilities coming from future bank recapitalization needs and liabilities of the electricity distribution companies may also push the debt trajectory up above the 70% benchmark, before the debt-to-GDP ratio declines gradually in the medium term. On the other hand, the captive domestic investor base is likely to mitigate the impact of any real interest rate shocks.

### 1. India's public debt sustainability analysis is based on the following assumptions:

- **Macroeconomic assumptions.** Growth is forecast at 4.6 percent (at factor cost) in 2013/14,<sup>3</sup> and should slowly return to trend in the medium term (at around 6¾ percent). The WPI is expected to fall from 7½ percent in 2012/13 to around 5¼ percent in the medium term. Similarly, the CPI is projected to decline from 10½ percent in 2012/13 to around 6½ percent in 2018/19. This baseline scenario assumes continued implementation of structural reforms that do not require legislative approval, and a relatively benign global economic recovery scenario as outlined in the WEO.
- **Fiscal Assumptions.** The 2013/14 central government budget deficit is expected to reach the authorities' deficit target of 4.8 percent of GDP, which corresponds to 5.3 percent under the Fund's definition. Over the medium term, this is expected to decline slowly toward 5.1 percent of GDP, while state government deficits should decline to 2 percent of GDP.
  - Tax performance, especially for income taxes, is expected to increase slightly as ongoing administrative measures continue to be implemented and base broadening is expected to continue. Goods and Services Tax is not assumed in this baseline as it requires legislative changes, including a constitutional amendment.
  - At the same time, some savings are likely to be found from petroleum subsidies, as the diesel under-recoveries are eliminated, and the planned gradual introduction of cash

<sup>1</sup> Prepared by Ran Bi (SPR), Mehdi Raissi, and Rahul Anand.

<sup>2</sup> The analysis of public debt sustainability is based on the framework developed for market access countries. See [Staff Guidance Note for Public Debt Sustainability Analysis in Market Access Countries](#), IMF, May 2013.

<sup>3</sup> The real GDP growth rates presented in the public and external DSA tables are based on market prices, as required by WEO. However, to be consistent with the authorities' measure of real GDP, the text here and other macro tables present real GDP growth at factor cost.

transfers should help rationalize spending over the medium term. However, the recently enacted Food Security Act will keep the subsidy bill high.

- Public banks are expected to be recapitalized to reach Basel III targets and some of the debts of electricity distribution companies are to be assumed by the government, in line with recent announcements.

**2. Under the baseline projection, India's debt ratio and gross financing needs will enter a declining path from 2014/15.** India's primary deficit is projected to decline below its debt-stabilizing threshold (estimated at 3.2 percent of GDP based on the 2018/19 projections) in 2013/14 and continue to improve gradually over the medium term. Therefore, gross financing needs are expected to remain at 12¾–13 percent of GDP in 2013/14–2014/15 before gradually declining to 11¾ percent in 2018/19. Automatic debt dynamics arising from the interest rate-growth differential will on average reduce the debt ratio by some 2¾ percentage points per year from 2013/14 to 2018/19. As a result, public debt-to-GDP ratio is expected to fall from 67¾ percent in 2013/14 to 64 percent in 2018/19. This is a more modest debt reduction than envisaged in the last staff report, which projected a debt-to-GDP ratio of around 60 percent by 2017/18. The slower pace of debt reduction is due to the weaker growth outlook (especially in the near term) and implementation of the Food Security Act.

**3. India faces relatively low risks to debt sustainability under the baseline, but it could be vulnerable to a slower real GDP growth and a contingent liability shock.** The heat map suggests that the debt burden benchmark and the gross financing needs threshold are exceeded under one or both of these two shocks. A one-standard deviation shock to GDP growth pushes the debt-to-GDP ratio to 72 percent in 2015/16, while under the financial sector contingent liability shock (which could arise from losses at public banks),<sup>4</sup> the debt-to-GDP ratio peaks at 76 percent in 2015/16. Both shocks, however, do not change the downward debt trajectory in the medium term. The lack of fiscal adjustment is another principal risk to debt sustainability in India's context. An unchanged primary balance would raise the debt ratio to 68 percent in 2015/16 before trending downward. Finally, the combined macro-fiscal shock also has a large level effect but does not change the direction of the debt trajectory. The debt profile, on the other hand, is at risk to market perception shocks and external financing requirements. In fact, a real interest rate shock would slow down debt reduction considerably. However, these two shocks are not very relevant for India given that most of the debt is financed through a captive domestic investor base, the very small external debt is mostly from official creditors, and more than adequate international reserves are available in the rare case that external financing needs arise. The upside risks include better tax buoyancy, a GST and a new Direct Tax Code that improve efficiency and lead to near-term revenue gains. A strong revival of the economy could also return India to the debt dynamics prevailing before the global financial crisis.

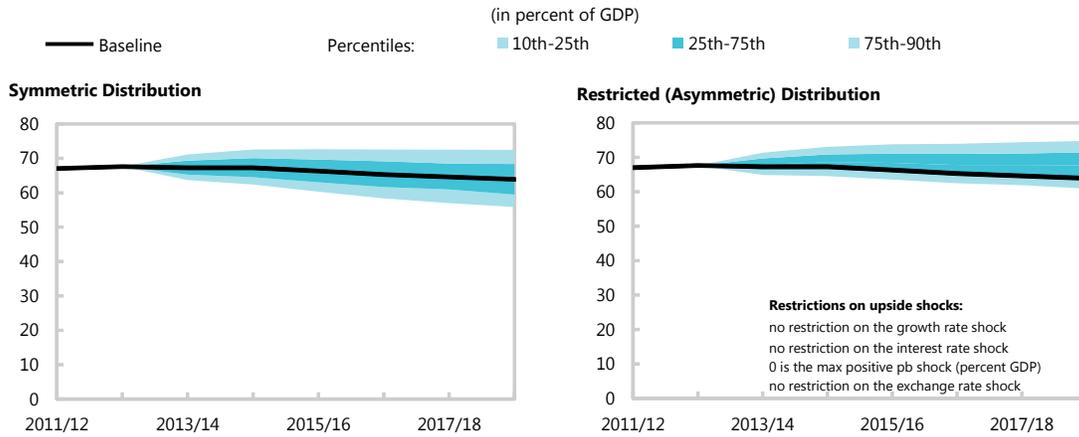
<sup>4</sup> Due to the lack of data on the actual public bank recapitalization needs, the default shock of 10 percent of total banking sector assets is used.

**4. There is no evidence of a systematic projection bias in the baseline assumptions and the projected fiscal adjustment is in line with other countries' experiences.** India's forecast track record is comparable to that of all other surveillance countries. The median forecast error for the primary balance and inflation during 2004–12 is at around 1 percent of GDP and in line with other countries. Forecast error for real GDP growth, however, is somewhat larger than in other countries given India's economic growth volatility. India's projected fiscal adjustment (an improvement of around ½ percentage points in cyclically-adjusted primary balance/GDP over the medium term) is very modest and should be achievable. This magnitude of adjustment is also in line with other countries' experiences, with a 3-year adjustment in cyclically-adjusted primary balance at 38 percentile among all surveillance countries. Finally, the boom-bust analysis is triggered because India had a positive output gap in 2010–12 before a negative gap opened in 2013. The baseline projection captures the boom-bust cycle but also reflects India's higher real growth rate, even in the downturns, than other highly-indebted market access countries.

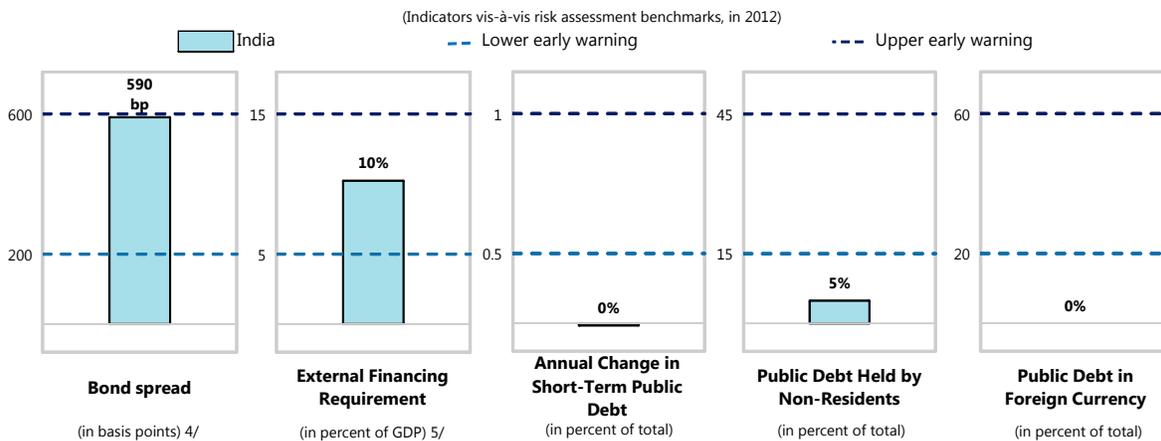
### Annex VI. Figure 1. India Public DSA—Risk Assessment Heat Map

Debt level <sup>1/</sup>	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs <sup>2/</sup>	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile <sup>3/</sup>	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

#### Evolution of Predictive Densities of Gross Nominal Public Debt



#### Debt Profile Vulnerabilities



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

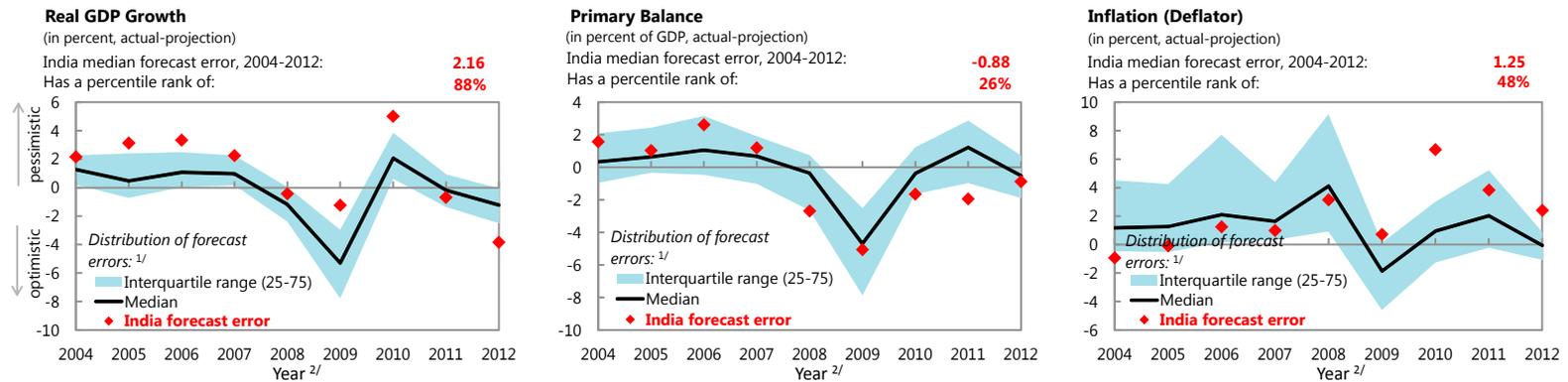
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 06-Sep-13 through 05-Dec-13.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

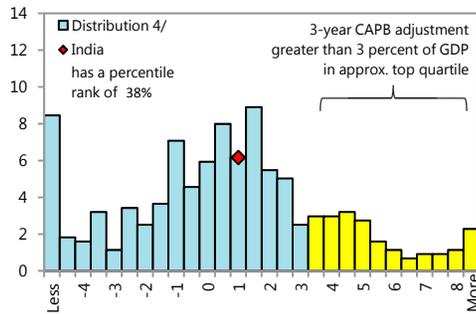
## Annex VI. Figure 2. India Public DSA—Realism of Baseline Assumptions

### Forecast Track Record, versus surveillance countries

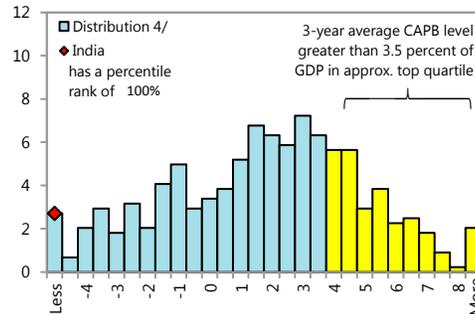


### Assessing the Realism of Projected Fiscal Adjustment

#### 3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB) (Percent of GDP)

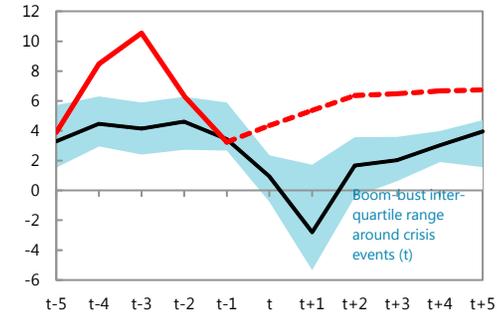


#### 3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB) (Percent of GDP)



### Boom-Bust Analysis<sup>3/</sup>

#### Real GDP growth (in percent)



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ India has had a positive output gap for 3 consecutive years, 2010-2012. For India, t corresponds to 2013; for the distribution, t corresponds to the first year of the crisis.

4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

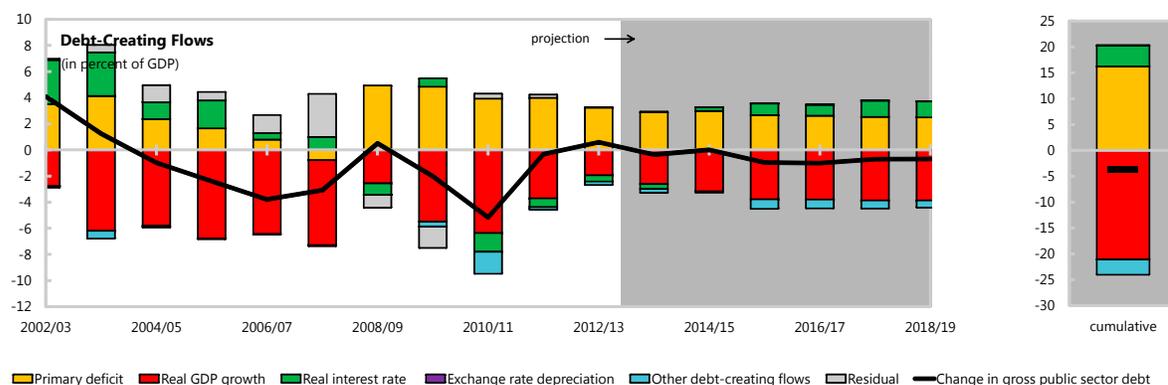
## Annex VI. Figure 3. India Public DSA—Baseline Scenario

(in percent of GDP unless otherwise indicated)

	Debt, Economic and Market Indicators <sup>1/</sup>									As of December 05, 2013			
	Actual			Projections									
	2002/03-2010/11 <sup>2/</sup>	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	EMBIG (bp) 3/	5Y CDS (bp)	Ratings	Foreign
Nominal gross public debt	77.4	67.0	67.6	67.3	67.3	66.3	65.3	64.6	63.9	593			
Public gross financing needs	11.7	13.4	12.8	12.3	13.1	12.6	12.2	12.0	11.8	328			
Real GDP growth (in percent)	7.9	6.3	3.2	4.4	5.4	6.4	6.5	6.7	6.7		Moody's	Baa2	Baa3
Inflation (GDP deflator, in percent)	5.9	8.3	8.2	8.2	7.6	6.4	6.4	5.6	5.6		S&Ps	BBB	BBB
Nominal GDP growth (in percent)	14.3	15.1	11.7	12.9	13.3	13.2	13.3	12.7	12.7		Fitch	BBB-	BBB-
Effective interest rate (in percent) <sup>4/</sup>	7.9	7.7	7.6	7.9	8.4	8.3	8.2	8.1	8.0				

## Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance <sup>9/</sup>
	2002/03-2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19		
Change in gross public sector debt	-1.3	-0.3	0.6	-0.4	0.0	-1.0	-1.0	-0.7	-0.7	-3.7	
Identified debt-creating flows	-1.8	-0.6	0.6	-0.4	0.0	-1.0	-1.0	-0.7	-0.7	-3.7	
Primary deficit	2.8	4.0	3.2	2.9	3.0	2.7	2.6	2.5	2.5	16.2	
Primary (noninterest) revenue and grants	19.2	18.8	19.5	19.6	19.8	19.8	19.9	20.1	20.3	119.5	
Primary (noninterest) expenditure	22.1	22.8	22.8	22.6	22.8	22.5	22.5	22.6	22.8	135.7	
Automatic debt dynamics <sup>5/</sup>	-4.3	-4.4	-2.4	-3.0	-2.9	-2.9	-3.0	-2.6	-2.6	-17.0	
Interest rate/growth differential <sup>6/</sup>	-4.3	-4.4	-2.4	-3.0	-2.9	-2.9	-3.0	-2.6	-2.6	-17.0	
Of which: real interest rate	1.1	-0.7	-0.5	-0.4	0.3	0.9	0.8	1.2	1.2	4.1	
Of which: real GDP growth	-5.4	-3.7	-1.9	-2.6	-3.2	-3.8	-3.8	-3.9	-3.9	-21.1	
Exchange rate depreciation <sup>7/</sup>	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.3	-0.2	-0.3	-0.3	-0.1	-0.7	-0.7	-0.6	-0.5	-2.9	
Privatization Receipts	-0.3	-0.2	-0.3	-0.3	-0.1	-0.7	-0.7	-0.6	-0.5	-2.9	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes <sup>8/</sup>	0.6	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as  $[(r - p(1+g) - g + ae(1+r))/(1+g+p+pp)]$  times previous period debt ratio, with  $r$  = interest rate;  $p$  = growth rate of GDP deflator;  $g$  = real GDP growth rate; $a$  = share of foreign-currency denominated debt; and  $e$  = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).6/ The real interest rate contribution is derived from the denominator in footnote 5 as  $r - \pi(1+g)$  and the real growth contribution as  $-g$ .7/ The exchange rate contribution is derived from the numerator in footnote 5 as  $ae(1+r)$ .

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

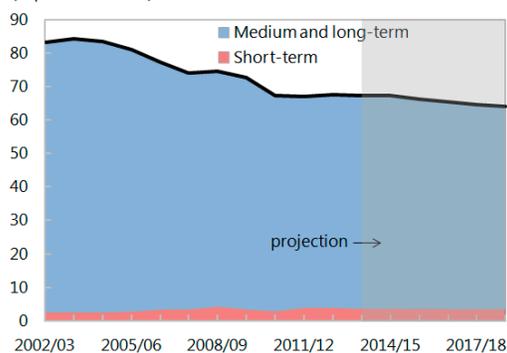
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

## Annex VI. Figure 4. India Public DSA—Composition of Public Debt and Alternative Scenarios

## Composition of Public Debt

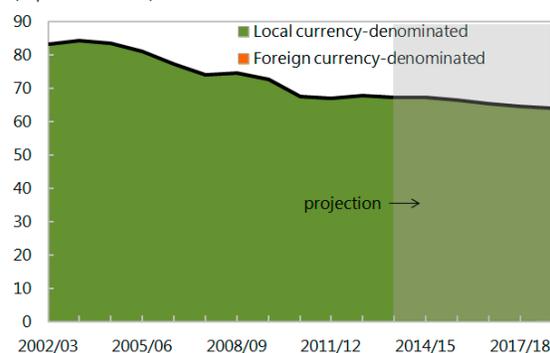
## By Maturity

(in percent of GDP)



## By Currency

(in percent of GDP)



## Alternative Scenarios

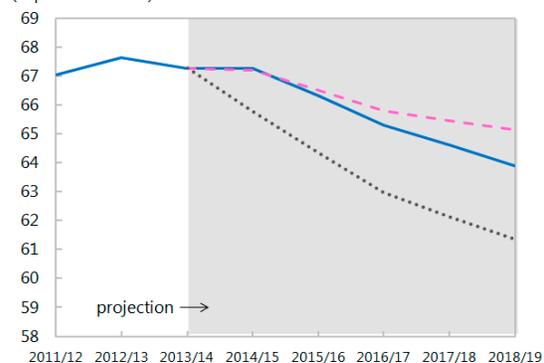
■ Baseline

..... Historical

- - - Constant Primary Balance

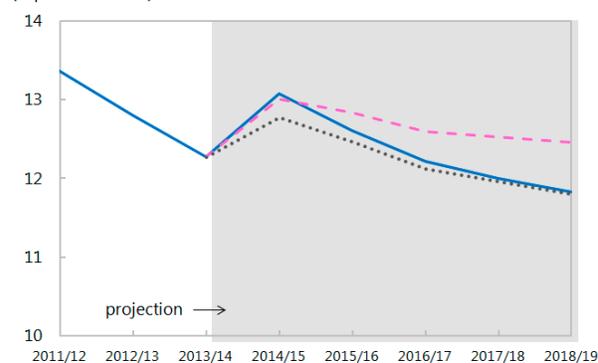
## Gross Nominal Public Debt

(in percent of GDP)



## Public Gross Financing Needs

(in percent of GDP)



## Underlying Assumptions

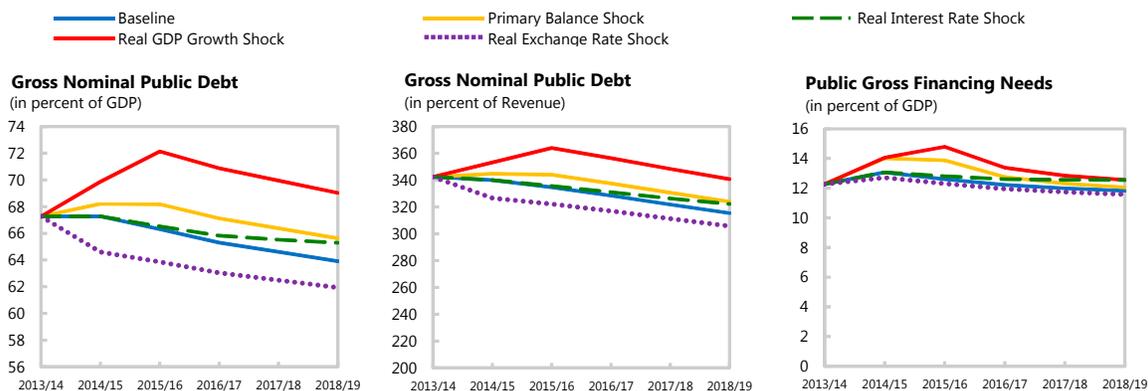
(in percent)

Scenario	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
<b>Baseline Scenario</b>						
Real GDP growth	4.4	5.4	6.4	6.5	6.7	6.7
Inflation	8.2	7.6	6.4	6.4	5.6	5.6
Primary Balance	-2.9	-3.0	-2.7	-2.6	-2.5	-2.5
Effective interest rate	7.9	8.4	8.3	8.2	8.1	8.0
<b>Constant Primary Balance Scenario</b>						
Real GDP growth	4.4	5.4	6.4	6.5	6.7	6.7
Inflation	8.2	7.6	6.4	6.4	5.6	5.6
Primary Balance	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Effective interest rate	7.9	8.4	8.3	8.2	8.1	8.0
<b>Historical Scenario</b>						
Real GDP growth	4.4	7.7	7.7	7.7	7.7	7.7
Inflation	8.2	7.6	6.4	6.4	5.6	5.6
Primary Balance	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Effective interest rate	7.9	8.4	8.3	8.1	8.0	7.9

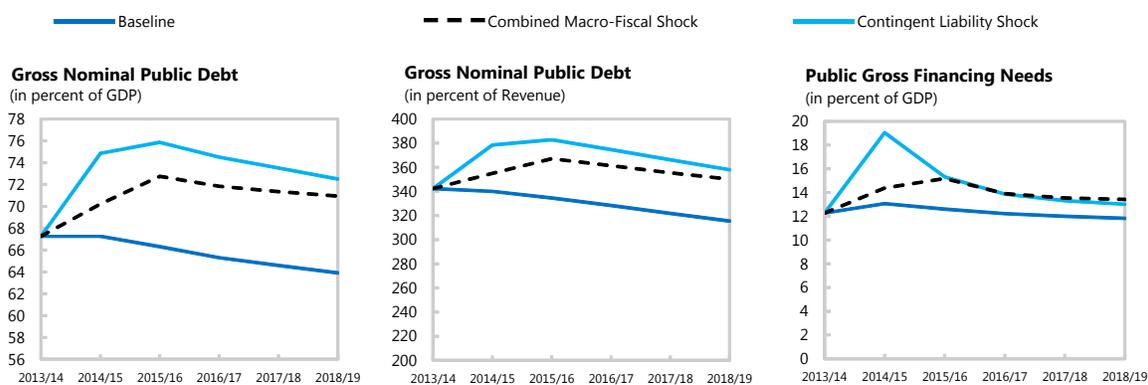
Source: IMF staff.

## Annex VI. Figure 5. India Public DSA—Stress Tests

## Macro-Fiscal Stress Tests



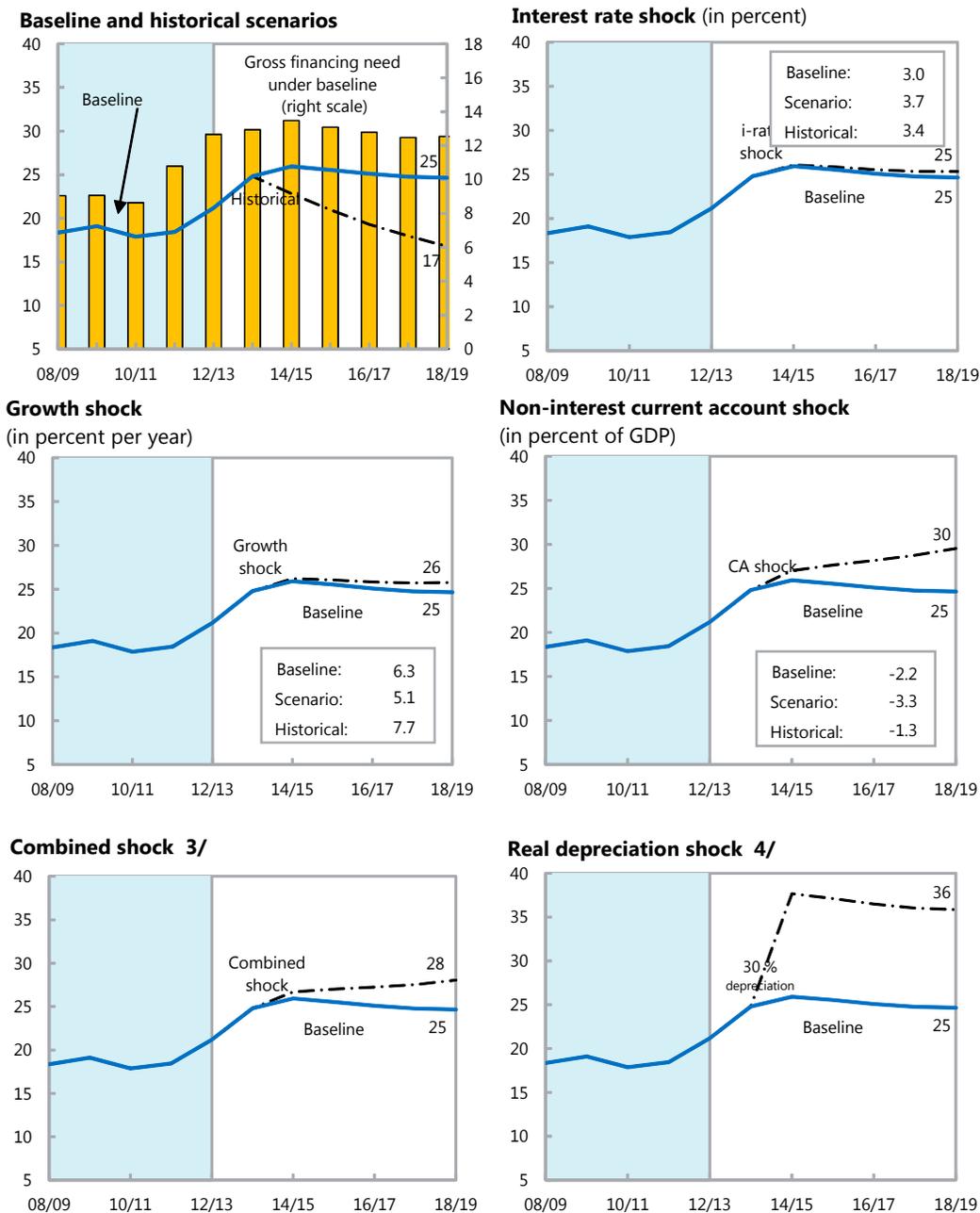
## Additional Stress Tests

Underlying Assumptions  
(in percent)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
<b>Primary Balance Shock</b>						
Real GDP growth	4.4	5.4	6.4	6.5	6.7	6.7
Inflation	8.2	7.6	6.4	6.4	5.6	5.6
Primary balance	-2.9	-3.9	-3.6	-2.6	-2.5	-2.5
Effective interest rate	7.9	8.4	8.4	8.3	8.2	8.1
<b>Real Interest Rate Shock</b>						
Real GDP growth	4.4	5.4	6.4	6.5	6.7	6.7
Inflation	8.2	7.6	6.4	6.4	5.6	5.6
Primary balance	-2.9	-3.0	-2.7	-2.6	-2.5	-2.5
Effective interest rate	7.9	8.4	8.7	8.8	8.9	8.9
<b>Combined Shock</b>						
Real GDP growth	4.4	2.9	3.9	6.5	6.7	6.7
Inflation	8.2	7.0	5.8	6.4	5.6	5.6
Primary balance	-2.9	-3.9	-4.0	-2.6	-2.5	-2.5
Effective interest rate	7.9	8.6	8.8	8.9	8.9	9.0
<b>Real GDP Growth Shock</b>						
Real GDP growth	4.4	2.9	3.9	6.5	6.7	6.7
Inflation	8.2	7.0	5.8	6.4	5.6	5.6
Primary balance	-2.9	-3.7	-4.0	-2.6	-2.5	-2.5
Effective interest rate	7.9	8.4	8.4	8.3	8.2	8.1
<b>Real Exchange Rate Shock</b>						
Real GDP growth	4.4	5.4	6.4	6.5	6.7	6.7
Inflation	8.2	12.4	6.4	6.4	5.6	5.6
Primary balance	-2.9	-3.0	-2.7	-2.6	-2.5	-2.5
Effective interest rate	7.9	8.6	8.4	8.3	8.2	8.1
<b>Contingent Liability Shock</b>						
Real GDP growth	4.4	2.9	3.9	6.5	6.7	6.7
Inflation	8.2	7.0	5.8	6.4	5.6	5.6
Primary balance	-2.9	-8.2	-2.7	-2.6	-2.5	-2.5
Effective interest rate	7.9	9.1	8.6	8.4	8.3	8.2

Source: IMF staff.

**Annex VI. Figure 6. India: External Debt Sustainability: Bound Tests 1/ 2/**  
**(External debt in percent of GDP)**



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks.

Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2014/15.

**Annex VI. Table 1. India: External Debt Sustainability Framework, 2008–2018**  
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -3.7	
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018		
<b>Baseline: External debt</b>	18.4	19.1	17.9	18.4	21.2	<b>24.8</b>	<b>25.9</b>	<b>25.5</b>	<b>25.1</b>	<b>24.8</b>	<b>24.6</b>		
Change in external debt	0.2	0.8	-1.2	0.6	2.7	3.6	1.1	-0.4	-0.4	-0.3	-0.1		
Identified external debt-creating flows (4+8+9)	1.5	-2.9	-3.4	0.5	2.4	1.4	-0.5	-1.1	-1.2	-1.4	-1.4		
Current account deficit, excluding interest payments	1.6	2.3	2.3	3.6	4.8	2.9	2.6	2.4	2.2	1.9	1.8		
Deficit in balance of goods and services	-53.6	-46.8	-49.6	-55.0	-56.2	-57.2	-58.5	-57.8	-57.1	-56.2	-55.8		
Exports	24.1	20.4	22.4	24.1	24.6	25.6	26.5	26.2	26.0	25.6	25.5		
Imports	-29.5	-26.4	-27.2	-30.8	-31.7	-31.5	-32.0	-31.6	-31.1	-30.6	-30.4		
Net non-debt creating capital inflows (negative)	-0.7	-3.7	-2.3	-2.1	-2.5	-1.0	-2.3	-2.5	-2.5	-2.5	-2.5		
Automatic debt dynamics 1/	0.6	-1.5	-3.4	-1.1	0.1	-0.5	-0.7	-0.9	-0.8	-0.7	-0.7		
Contribution from nominal interest rate	0.7	0.5	0.4	0.6	0.0	0.4	0.5	0.6	0.7	0.8	0.8		
Contribution from real GDP growth	-0.7	-1.4	-1.6	-1.0	-0.6	-0.9	-1.3	-1.5	-1.5	-1.5	-1.5		
Contribution from price and exchange rate changes 2/	0.6	-0.6	-2.2	-0.6	0.7	...	...	...	...	...	...		
Residual, incl. change in gross foreign assets (2-3) 3/	-1.2	3.6	2.2	0.1	0.3	2.2	1.6	0.7	0.7	1.0	1.3		
External debt-to-exports ratio (in percent)	76.1	93.7	79.8	76.4	86.2	96.8	97.8	97.3	96.7	96.6	96.8		
<b>Gross external financing need (in billions of US dollars) 4/</b>	110.7	123.8	147.8	202.1	233.0	239.6	259.4	275.3	294.1	314.0	343.7		
in percent of GDP	9.0	9.1	8.6	10.8	12.6	10-Year	10-Year	12.9	13.5	13.1	12.8	12.5	12.5
<b>Scenario with key variables at their historical averages 5/</b>						<b>24.8</b>	<b>22.8</b>	<b>21.0</b>	<b>19.3</b>	<b>18.0</b>	<b>16.8</b>	<b>-3.8</b>	
<b>Key Macroeconomic Assumptions Underlying Baseline</b>						Historical Average	Standard Deviation						
Real GDP growth (in percent)	3.9	8.5	10.5	6.3	3.2	7.7	2.5	4.4	5.4	6.4	6.5	6.7	
GDP deflator in US dollars (change in percent)	-4.9	2.9	13.4	2.9	-4.7	5.6	7.4	-3.7	-1.2	2.6	2.6	2.6	
Nominal external interest rate (in percent)	3.8	2.8	2.7	3.4	0.0	3.4	1.3	2.0	2.2	2.5	3.1	3.6	
Growth of exports (US dollar terms, in percent)	15.0	-5.6	37.7	17.9	0.0	20.6	14.3	4.9	7.6	8.1	8.1	8.2	
Growth of imports (US dollar terms, in percent)	16.6	0.0	29.0	24.2	0.9	22.6	15.1	0.1	5.7	7.7	7.7	8.0	
Current account balance, excluding interest payments	-1.6	-2.3	-2.3	-3.6	-4.8	-1.3	2.2	-2.9	-2.6	-2.4	-2.2	-1.9	
Net non-debt creating capital inflows	0.7	3.7	2.3	2.1	2.5	2.2	0.9	1.0	2.3	2.5	2.5	2.5	

1/ Derived as  $[r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$  times previous period debt stock, with  $r$  = nominal effective interest rate on external debt;  $r$  = change in domestic GDP deflator in US 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  $[-r(1+g) + ea(1+r)] / (1+g+r+gr)$  times previous period debt stock.  $r$  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.  
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.  
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.



# INDIA

## STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 9, 2014

Prepared By

Asia and Pacific Department

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## FUND RELATIONS

(As of November 30, 2013)

### Membership Status:

Joined December 27, 1945; Article VIII.

### General Resources Account

	SDR Million	% Quota
Quota	5,821.50	100.00
Fund Holdings of Currency (Exchange Rate)	4,166.94	71.58
Reserve Tranche Position	1,654.78	28.43
Lending to the Fund		
New Arrangements to Borrow	1,087.00	

### SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	3,978.26	100.00
Holdings	2,887.50	72.58

**Outstanding Purchases and Loans:** None

### Financial Arrangements:

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

### Projected Payments to Fund

(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming			
	2014	2015	2016	2017
Principal				
Charges/interest	1.11	1.11	1.11	1.11
<b>Total</b>	<b>1.11</b>	<b>1.11</b>	<b>1.11</b>	<b>1.11</b>

**Exchange Rate Arrangement:**

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

**Article IV Consultation:**

The previous Article IV consultation discussions were held in November 2012. The staff report (IMF Country Report No. 13/37) was discussed by the Executive Board on January 25, 2013.

**FSAP Participation and ROSCs:**

FSSA/FSAP report was issued in January 2001; a fiscal transparency ROSC was issued in February 2001 (<http://www.imf.org/external/np/rosc/ind/fiscal.htm>); the data model of the ROSC (Country Report No. 04/96) was issued in April 2004. The missions for the FSAP Update took place in 2011, and concluding meetings were held in Delhi and Mumbai in January 2012—the FSSA Update report was published in January 2013 (Country Report No. 13/8). Detailed assessment reports on FSAP-related papers were issued in August 2013 and published as Country Reports No. 13/265–268.

**Technical Assistance:**

<b>Dept</b>	<b>Purpose</b>	<b>Date of Delivery</b>
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
STA	Workshop on national accounts	03/10
LEG	Insolvency regime workshop	7/13

**Outreach and Other Activities:**

<b>Dept</b>	<b>Purpose</b>	<b>Date of Delivery</b>
APD	International Conference on Public Finance, Public Economics and Public Policy	11/12
APD	Interviews on FSSA publication, NDTV, Bloomberg	01/13
APD	Interview on world economic outlook, Newswire 18	02/13
APD	Conference: International Conference on Contemporary Debates in Public Policy and Management	02/13
APD	Interview on India economic outlook, NDTV	02/13
APD	Presentation on global outlook and implications for India, Delhi University	02/13
APD	ASSOCHAM International Summit on "Infrastructure Finance--Building for Growth"	03/13
APD	Presentation on India economic outlook, ICRIER, New Delhi	03/13
APD	Panel discussion, Economist Summit	04/13
APD	Interviews on WEO, CNBC, ET Now, NDTV, Bloomberg	04/13
APD	ICRIER – IMF Conference on Fiscal Policy in Asia, New Delhi	04/13
APD	Op-ed: The Challenge of Raising Indian Growth in Today's Global Environment in Business Standard	05/13
APD	Interview on WEO, NDTV	07/13
APD	Interview, Financial Times	08/13
APD	Interview, NDTV	08/13
APD	Dun & Bradstreet "India 2020 Economic Outlook," panel discussion	08/13
APD	G-20 Conference, ICRIER, New Delhi	09/13
APD	Interview, "India Needs Structural Reforms to Reduce Bottlenecks to Investment," in <u>Business Standard</u>	10/13
APD	Op-ed: Asia's Still Going Strong in Times of India	10/13

**Resident Representative:**

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

## RELATIONS WITH THE WORLD BANK GROUP

In Bank FY13 (July 1, 2012–June 30, 2013), IBRD/IDA lending in India totaled US\$1.3 billion. IFC committed US\$1.4 billion in FY13. The new World Bank Group’s (WBG) Country Partnership Strategy (CPS) for India for 2013-2017 focuses on helping India to accelerate poverty reduction and boost shared prosperity. The CPS is guided by the Government of India’s “Innovation Impulse with Investment” approach, which lays out the Government’s vision of how best to use the financing and expertise from multilateral institutions to address India’s development challenges and places significant importance on the value-added of the World Bank’s program that goes well beyond financing. It wants to partner with the WBG on projects that have a systemic and transformational impact, those that help innovate and pilot new approaches, and those that help leverage resources. The strategy is closely aligned the Government’s 12<sup>th</sup> Five-Year Plan, and its goal of “faster, sustainable, and more inclusive growth.”

Under the new CPS, the WBG will contribute to India’s development by deepening and strengthening WBG engagement in three priority areas: integration, rural-urban transformation and inclusion. A common theme across these areas will be an emphasis on improved governance, environmental sustainability, and gender equality. “Integration” will include addressing infrastructure gaps as one of the key measures needed to help low-income states converge more quickly with their faster-growing neighbors. With 600 million people expected to live in India’s cities by 2031, “transformation” will require intensified engagement over the strategy period and beyond on improving the management and livability of medium-sized cities. The rural-urban transformation presents tremendous opportunities, both for agriculture and poverty reduction, and competitiveness. Supporting urbanization is a key structural shift in the CPS. “Inclusion” will entail a stronger focus on human development with improvements in healthcare systems and nutrition, on the quality of education at all levels, as well as on better access to finance and social protection for the underprivileged.

A second significant shift in WBG support is towards 14 low-income and special category states<sup>1</sup>, where many of India’s poor and disadvantaged live. Over the next five years, the Bank will work with the Government to rebalance the lending portfolio, so that 30 percent of all IBRD/IDA lending will be directed to these states, which together account for 400 million (one-third of India’s poor people living on less than \$1.25 per day). Many of these states also have human development indicators—high infant mortality, high child malnutrition, low female literacy—on par with the poorest countries in the world. IFC has also intensified its program in low-income states; annual commitments have more than quadrupled in the last five years from \$60 million in FY09 to \$273 million in FY13.

<sup>1</sup> Low-income and special category states include: Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Odisha, Rajasthan, Uttar Pradesh, and eight northeast states (Assam, Himachal Pradesh, Manipur, Meghalaya, Mizoram, Sikkim, and Uttarakhand). IFC also includes West Bengal, but excludes Himachal Pradesh and Uttarakhand.

Engagement in more advanced states and at the central level will focus on activities that are transformative and innovative. Projects are expected to test second-generation approaches, which overtime could be scaled up and replicated in low-income states.

To make a meaningful contribution to India's many development challenges and to meet the Millennium Development Goals, the volume of WBG support—from IBRD, IDA, and IFC— should reach \$5 billion annually over the next five years. A robust knowledge portfolio will complement and underpin financing and includes (i) focus on in-depth analytical work on key cross-sectoral questions; (ii) inform design and implementation of future interventions by drawing on impact evaluations; (iii) respond quickly and flexibly with demand-driven technical assistance and just-in-time knowledge support to help reform and implementation; (iv) broker South-South and across-state knowledge exchanges; (v) develop flexible programmatic approaches to develop analytic and advisory activities; and (vi) scale-up training capacity. Aligned with its regional strategy, IFC's Advisory Services program in India is aligned with the regional strategy on inclusion facilitating access to services for base of pyramid populations, and expanding the private sector's footprint in low-income states), climate change, and global integration.

#### India: World Bank Financial Operations

	(In millions of U.S. dollars) <sup>1/</sup>
	2012/13 <sup>2/</sup>
<b>Commitments<sup>3/</sup></b>	<b>2,405</b>
IBRD	1,037
IDA	1,368
<b>Disbursements</b>	<b>1,685</b>
IBRD	801
IDA	884
<b>Repayments</b>	<b>1,493</b>
IBRD	649
IDA	844
<b>Debt outstanding and disbursed</b>	<b>38,366</b>
IBRD	11,874
IDA	26,492

Source: World Bank

1/ On an Indian fiscal year basis beginning April 1

2/ April 1, 2012 through March 31, 2013.

3/ Based on loan approval date.

## RELATIONS WITH THE ASIAN DEVELOPMENT BANK

The Asian Development Bank (AsDB) operations in India began in 1986. Cumulative public sector loan commitments totaled \$28.4 billion as of 31 October 2013 for 175 loans. With an additional \$2.2 billion in private sector loans (the latter without government guarantee), total loan commitments on a cumulative basis amount to \$30.6 billion. These funds have been provided from AsDB's ordinary capital resources (OCR). Also, AsDB has approved equity investments amounting to \$0.3 billion. AsDB's lending and equity activities are summarized below.

India: Asian Development Bank Financial Operations (sovereign and non-sovereign)  
(In millions of U.S. dollars, as of 31 October 2013)

Calendar Year	OCR Loan Commitments	Private Equity	Disbursements
1986–90	2,361.3	15.9	354.3
1991–95	3,456.0	59.5	2,222.8
1996	763.0	--	605.6
1997	563.0	15.5	645.0
1998	250.0	--	620.4
1999	625.0	--	605.1
2000	1,330.0	--	487.0
2001	1,500.0	--	269.8
2002	1,183.6	15.0	576.5
2003	1,493.0	0.7	658.2
2004	1,200.0	29.7	401.6
2005	417.3	15.0	698.3
2006	1,485.0	67.6	711.9
2007	1,311.4	--	1,493.2
2008	2,482.6	18.6	1,655.6
2009	1,811.0	40.0	1,551.7
2010	2,119.6	0.0	1,858.1
2011	2,872.9	20.0	1,544.6
2012	2,190.0	--	1,444.8
2013	1,140.4*	32.0*	837.3*
<b>Total</b>	<b>30,555.1</b>	<b>329.3</b>	<b>19,208.9</b>

Source: Asian Development Bank.

\*As of 31 October 2013.

AsDB's India Country Partnership Strategy (2013-2017) (CPS) is based on three strategic pillars: (i) inclusive growth; (ii) environmental sustainability; and (iii) regional cooperation and integration. The

## INDIA

CPS is anchored to AsDB's Strategy 2020 and has been designed to support the Government of India's 12th Five Year Plan (2012–2017) vision of faster, more inclusive, and sustainable growth. The CPS emphasizes robust infrastructure development, job creation and access to jobs, regional connectivity, and environmental sustainability. The backbone of the India program will be energy, transport, and urban services. On a selective basis, ADB will also invest in special purpose vehicles for infrastructure financing, water resources management, skills development, and state-level fiscal reforms.

## STATISTICAL ISSUES

1. Macroeconomic statistics are adequate for surveillance, but weaknesses remain in the timeliness and coverage of certain statistical series. India has an intricate system for compiling economic and financial statistics and produces a vast quantity of data covering most sectors of the economy, but these do not always follow international standards. India subscribed to the Special Data Dissemination Standards (SDDS) on December 27, 1996 and started posting its metadata on the Dissemination Standards Bulletin Board on October 30, 1997. It is currently in observance of the SDDS, although it uses flexibility options for timeliness of data on general government operations and on the periodicity and timeliness of labor market data.
2. The data module of the Report on Observance of Standards and Codes (ROSC, IMF Country Report No. 04/96) was published in April 2004. It assesses India's data dissemination practices against the SDDS requirements and assesses the quality of six datasets based on the Data Quality Assessment Framework (DQAF) developed by STA.
3. **National accounts and employment statistics:** The Central Statistical Organization (CSO) releases a new series of national accounts, with base year 2004–2005 with a dissemination lag for quarterly releases of two months. Large revisions to historical series and major discrepancies between supply and expenditure national accounts complicate analysis: these differences have become larger in recent quarters. Supply-side data remain of better quality than expenditure-side data. Estimates of value added in constant prices for public administration and defense may be biased upwards, as they are based on the government's wage bill (with arrears counted in the year that they are paid) deflated by the Wholesale Price Index (WPI). There are long standing deficiencies in employment data: they are only available on an annual basis and with a substantial lag, and they only cover the formal sector, which accounts for a small segment of the labor market.
4. **Price statistics:** Since January 2006, the Labour Bureau has published a CPI for industrial workers with a 2001 base year. A revised all-India CPI with new weights was unveiled in early 2011. Presently, there are four CPIs, each based on the consumption basket of a narrow category of consumers (namely industrial workers, urban and non-manual employees, agricultural laborers, and rural laborers). The CPIs are published with a lag of about one month. With the exception of the industrial workers CPI, the other indices are based on weights that are over ten years. The WPI was also recently revised and has a 2004/05 base year. Data are also subject to frequent and large revision, usually upward. New RBI price series on residential real estate have helped surveillance in this area, though geographic coverage remains limited, and price data for commercial real estate are not available. The RBI has started producing a series covering rural wage data, which helps surveillance, but economy-wide wage data are scant.
5. **External sector statistics:** While the concepts and definitions used to compile balance of payments statistics are broadly in line with the sixth edition of the Balance of Payments Manual

(BPM6), 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); trade credit is often less than 180 days in most countries. Bilateral data on services exports to the United States and other developed countries are manifold higher than counterpart services imports published by these same countries. External debt statistics are available on a quarterly basis with a one quarter lag. Estimates of short-term external debt are presented in the debt statistics on an original maturity basis. The short-term maturity attribution on a residual maturity basis is only available annually (and excludes residual maturity of medium- and long-term nonresident Indian accounts). The international investment position (IIP) statistics cover the sectors prescribed in the BPM6 and these data are disseminated within six months of the reference period in respect of annual data<sup>1</sup>. Coverage of direct investment positions data is hampered by the absence of appropriate legal or institutional authority. India began disseminating the Data Template on International Reserves and Foreign Currency Liquidity as prescribed under the SDDS in December 2001. The more up-to-date information on certain variables, such as total foreign reserves, foreign currency assets, gold, and SDRs, are available on a weekly basis and are disseminated as part of a weekly statistical supplement on the RBI web site.

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

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

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

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

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

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

## India: Table of Common Indicators Required for Surveillance

As of December 4, 2013

	Date of latest observation	Date received	Frequency of Data 1/	Frequency of Reporting 1/	Frequency of Publication 1/
Exchange Rates	12/04/13	12/04/13	D	D	D
International reserve assets and reserve liabilities of the monetary authorities 2/	11/22/13	11/29/13	W	W	W
Reserve/base money	11/22/13	11/29/13	W	W	W
Broad money	11/15/13	11/29/13	W	W	W
Central bank balance sheet	Nov. 2013	12/02/13	M	M	M
Consolidated balance sheet of the banking system	Aug. 2013	10/17/13	M	M	M
Interest rates 3/	12/04/13	12/04/13	D	D	D
Consumer price index	Oct. 2013	11/29/13	M	M	M
Revenue, expenditure, balance and composition of financing - General Government 4/ 5/	2011/12	03/09/13	A	A	A
Revenue, expenditure, balance and composition of financing - Central Government 4/ 5/	Oct. 2013	11/29/13	M	M	M
Stocks of central government and central government-guaranteed debt 6/	Oct. 2013	11/29/13	M	M	M
External current account balance	Sept. 2013	12/02/13	Q	Q	Q
Exports and imports of goods and services	Sept. 2013	12/02/13	Q	Q	Q
GDP/GNP	Sept. 2013	11/29/13	Q	Q	Q
Gross external debt	Jun. 2013	09/30/13	Q	Q	Q
International Investment Position	Jun. 2013	09/30/13	Q	Q	Q

1/ Daily (D), Weekly (W), Biweekly (BW), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA)

2/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

3/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

4/ Foreign, domestic bank, and domestic nonbank financing.

5/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state governments

6/ Including currency and maturity composition

**Statement by the IMF Staff Representative on India**  
**January 27, 2014**

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

***Economic and financial developments***

1. **Recent activity data point to continued weakness in economic activity.** Industrial production (IP) shrank by 2.1 percent y/y in November, following a 1.6 percent decline in October, as consumer durables contracted by double-digits. Capital goods production and mining remain weak. Both manufacturing and services PMIs declined in December, with services PMI remaining in a contractionary zone for six consecutive months.
2. **Headline CPI inflation has moderated, but core CPI inflation remained flat.** In December, headline CPI inflation declined to 9.9 percent y/y due largely to easing vegetable prices, while core CPI inflation remained flat at about 8 percent y/y. WPI inflation also declined to 6.2 percent y/y due to a moderation in food prices, even as core WPI inflation ticked up to 2.8 percent y/y. Market participants appear evenly split between those expecting higher rates, and those expecting unchanged rates, at the Reserve Bank of India's (RBI) January 28 monetary policy review.
3. **The trade deficit widened in December, but robust capital inflows have allowed a build up in international reserves.** The trade deficit widened to US\$10.1 billion from US\$ 9.2 billion in November. Imports continued to contract (15.2 percent decline y/y in December) reflecting weak domestic demand, while export growth slowed to 3.5 percent y/y from 5.9 percent y/y in November. International reserves now stand at US\$ 293 billion, about US\$ 3 billion higher than the stock of reserves held on May 22, 2013. This rise in reserves can largely be attributed to flows obtained through the RBI's foreign exchange swap window (non-resident Indian foreign currency deposits and banks' foreign currency borrowings) and equity inflows. Furthermore, net portfolio investment inflows (both equity and debt) have been about US\$ 7 billion since early-December.
4. **The Patel Committee (PC) in its report submitted to the Governor of the RBI on January 21, 2014, has called for a complete overhaul of the monetary policy framework in India.** It has recommended that inflation, as measured by all-India headline CPI inflation, should be the nominal anchor for the monetary policy framework. The focus on headline CPI, despite a large weight on food and fuel inflation in CPI, is considered a critical prerequisite for reducing and anchoring inflation expectations. Subject to the establishment and achievement of the nominal anchor, monetary policy should be consistent with a sustainable economic growth and financial stability. The PC's recommended target for inflation is 4 percent with a +/- 2 percent band around it, with the target to be formally

adopted after inflation is brought down to 8 percent over a period not exceeding the next 12 months and to 6 percent over a period not exceeding the next 24 months.

5. **To enhance monetary policy transmission, the PC report recommends a phased refinement of the current operating framework of monetary policy, liquidity management and its instruments in particular.** The overnight repo rate should continue to be a single policy rate, and the weighted average call rate the operating target. However, RBI's liquidity operations should be geared toward greater use of auctioned term repos (tenors up to three months) and as they gain acceptance among market participants for liquidity management, the 14-day term repo rate should serve as the operating target. In addition, the PC has recommended reducing the Statutory Liquidity Ratio, consistent with the path of fiscal consolidation, to a level fitting the requirements of the liquidity coverage ratio prescribed under the Basel III framework. The PC report proposes establishing a monetary policy committee (MPC), to enhance formulation, transparency, and accountability of monetary policy. The MPC would be chaired by the RBI Governor and comprise both internal and external members. The report also identifies the need to reduce the fiscal deficit to 3 percent of GDP by 2016/17, and calls for a commitment from the Government to eliminate administered setting of prices, wages, and interest rates as key institutional requirements for effective monetary policy transmission.

6. **The RBI has mandated banks to make additional provisions for unhedged foreign currency exposures from April 2014.** The RBI will require banks to make additional provisions if the estimated loss from unhedged exposure exceeds 15 percent of the company's earnings before tax, interest and depreciation (EBITDA), progressively raising the provision as estimated losses increase.



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FOR IMMEDIATE RELEASE  
February 20, 2014

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

### **IMF Executive Board Concludes 2014 Article IV Consultation with India**

On January 27, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation<sup>1</sup> with India.

India's growth has slowed markedly, reflecting global developments and domestic supply constraints, while inflation remains stubbornly high. Led by falling infrastructure and corporate investment, the slowdown has generalized to other sectors of the economy. The financial positions of banks and corporates have deteriorated. The combination of persistently-high inflation, sizeable current account and fiscal deficits intensified the global liquidity tightening-induced balance of payment pressures experienced during the summer, which resulted in significant portfolio debt outflows, and pressures on currency, equity and bond markets. Along with improving external conditions, positive policy steps taken by the authorities have improved market sentiment. The current account deficit, after reaching a record high in FY2012/13 (fiscal year ending March), is narrowing fast, and capital inflows have picked up. While recent policy initiatives have reduced vulnerabilities, the policy space remains strictly circumscribed because of high deficits and debt, and elevated inflation.

Growth is projected at 4.6 percent for fiscal year 2013/14, and should pick up to 5.4 percent in 2014/15 (at factor cost). Stronger global growth, improving export competitiveness, a favorable monsoon, and a confidence boost from recent policy actions should deliver a modest growth rebound. However, fiscal restraint and a tighter monetary stance will act as headwinds, slowing the recovery. CPI inflation is expected to remain near double-digits well into next year, driven by high food inflation that feeds quickly into wages and core inflation; entrenched inflation expectations; the pass through from a weaker rupee; and ongoing energy price increases. WPI inflation is forecast to remain above the Reserve Bank of India's comfort zone, given that supply constraints will ease only gradually. The current account deficit should narrow in fiscal year 2013/14 to about 3.3 percent of GDP, supported by rebounding exports, higher remittances, rapidly-shrinking gold imports, weakening domestic demand, and broadly stable oil prices.

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<sup>1</sup> 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.

The principal risk facing India is the inward spillover from global financial market volatility. Protracted economic and financial volatility (triggered by advanced economies' exit from unconventional monetary policies), a lengthy Euro area growth slowdown, and higher oil prices are the main external risks. Slow progress on structural reforms, high inflation, failure to ease supply constraints, and resorting to expansionary fiscal policy are key domestic downside risks. On the upside, going beyond announced reforms or faster-than-envisaged legislative progress would lead to higher growth and reduce economic vulnerabilities.

### **Executive Board Assessment<sup>2</sup>**

Executive Directors commended the Indian authorities for their ability to maintain macroeconomic and financial stability amid a challenging macroeconomic landscape. Directors welcomed ongoing efforts, including recent policy initiatives, to reduce external vulnerabilities, rebuild buffers, and revive investment. They noted, however, that growth has slowed markedly and inflation remains persistently high, while spillovers from global financial market volatility continue to pose a significant risk. Against this backdrop, Directors underscored the need to rein in inflation, prudently consolidate the fiscal position, and accelerate structural reforms to address supply bottlenecks and promote sustainable and inclusive growth.

Directors supported the central bank's policies of rupee flexibility and limited foreign exchange intervention. They welcomed the gradual, cautious move toward further external liberalization. Directors considered that these measures are important tools to deal with capital account pressures, which, if they were to re-emerge, should be complemented by judicious use of reserves, tightening of monetary conditions, and additional fiscal adjustment. Directors encouraged continued efforts to improve the financing of the current account deficit. Measures to facilitate foreign direct investment inflows and deepen domestic capital markets should continue to help reduce external vulnerabilities.

Given entrenched double-digit inflation expectations, Directors recommended that the authorities maintain the monetary policy stance appropriately tight, and stand ready to raise the policy rate further so as to bring down inflation to more sustainable levels. They welcomed recent initiatives to strengthen the monetary policy framework with a clear communication strategy, aimed at enhancing the effectiveness of monetary policy.

Directors commended the government's commitment to fiscal consolidation and supported its medium-term targets. To this end, they emphasized the need for a comprehensive package of measures, comprising both tax and subsidy reforms, to ensure the quality and sustainability of consolidation. Rationalizing fuel and fertilizer subsidies and introducing the

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<sup>2</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

goods and services tax are essential to create fiscal space, while safeguarding priority capital spending and targeted social programs, particularly health and education.

Directors stressed that reviving growth and raising the long-term growth potential require broader structural reforms to improve infrastructure, the business climate, and the pricing and allocation of natural resources. They also saw as key priorities reforms aimed at boosting agricultural productivity and supporting formal job creation, by relaxing labor laws and addressing skills mismatches.

Directors recognized that India's financial system is well capitalized and supervised, and welcomed progress in implementing the recommendations of the FSAP Update. They welcomed in particular recent measures to enhance supervision and increase bank provisioning. Directors noted nevertheless that deteriorating corporate financial positions and weakening bank balance sheets, especially among public banks, warrant close monitoring. They encouraged the authorities to further strengthen prudential regulation of banks' asset quality classification and concentration risks, and pay due regard to the inter-linkages between corporate vulnerabilities and banking system health. Steps are also needed to modernize the legal and insolvency framework.

## India: Selected Economic Indicators, 2009/10–2014/15 1/

I. Social Indicators						
GDP (2012/13)		Poverty (percent of population)				
Nominal GDP (in billions of U.S. dollars):	1,842	Headcount ratio at \$1.25 a day (2010):		32.7		
GDP per capita (U.S. dollars):	1,501	Undernourished (2011):		17.5		
Population characteristics (2012/13)		Income distribution (2010, WDI)				
Total (in billions):	1.2	Richest 10 percent of households:		28.8		
Urban population (percent of total):	32	Poorest 20 percent of households:		8.5		
Life expectancy at birth (years):	65	Gini index (2010):		33.9		
II. Economic Indicators						
	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
				Prel.	Proj.	Proj.
Growth (in percent)						
Real GDP (at factor cost)	8.6	9.3	6.2	5.0	4.6	5.4
Industrial production	5.3	8.2	2.9	1.1	...	...
Prices (percent change, period average)						
Wholesale prices (2004/05 weights)	3.8	9.6	8.9	7.4	6.4	6.7
Wholesale prices (2004/05 weights, end of period)	10.4	9.7	7.7	5.7	7.4	6.3
Consumer prices - industrial workers (2001 weights)	12.4	10.4	8.4	10.4	10.5	8.6
Saving and investment (percent of GDP)						
Gross saving 2/	33.7	34.2	30.8	30.8	31.5	31.8
Gross investment 2/	36.5	36.8	35.0	35.6	34.8	34.9
Fiscal position (percent of GDP) 3/						
Central government deficit	-7.0	-6.4	-6.0	-5.1	-5.3	-5.6
General government deficit	-9.8	-8.4	-8.5	-7.8	-7.7	-8.0
General government debt 4/	72.5	67.4	67.0	67.6	67.3	67.3
Structural balance (% of potential GDP)	-9.5	-9.0	-9.1	-7.9	-7.5	-7.8
Structural primary balance (% of potential GDP)	-4.7	-4.4	-4.5	-3.3	-2.8	-2.8
Money and credit (y/y percent change, end-period)						
Broad money	16.9	16.1	13.2	13.8	13.6	14.7
Credit to commercial sector 5/	15.8	21.3	17.0	14.2	16.3	...
Financial indicators (percent, end-period)						
91-day treasury bill yield (end-period) 5/	4.4	7.3	9.0	8.2	8.6	...
10-year government bond yield (end-period) 5/	7.8	8.0	8.6	8.0	8.8	...
Stock market (y/y percent change, end-period)	80.5	10.9	-10.5	8.2	...	...
External trade 6/						
Merchandise exports (in billions of U.S. dollars)	182.4	250.5	309.8	306.6	319.4	340.6
(Annual percent change)	-3.5	37.3	23.7	-1.0	4.2	6.6
Merchandise imports (in billions of U.S. dollars)	300.6	381.1	499.5	502.2	497.4	523.2
(Annual percent change)	-2.6	26.7	31.1	0.5	-1.0	5.2
Terms of trade, goods (annual percent change)	-0.7	-2.5	-3.1	-1.7	...	...
Balance of payments (in billions of U.S. dollars)						
Current account balance	-38.2	-45.9	-78.2	-88.2	-61.6	-59.9
(In percent of GDP)	-2.8	-2.7	-4.2	-4.8	-3.3	-3.1
Foreign direct investment, net	18.0	9.4	22.1	19.8	23.1	25.0
Portfolio investment, net (equity and debt)	32.4	30.3	17.2	26.9	-5.0	19.8
Overall balance	13.0	12.9	-13.1	3.4	4.5	17.8
External indicators						
Gross reserves (in billions of U.S. dollars, end-period)	279.1	304.8	294.4	292.0	296.6	314.3
(In months of imports) 7/	7.2	6.3	6.1	6.0	5.8	5.7
External debt (in billions of U.S. dollars, end-period)	260.9	305.9	345.5	390.0	459.1	499.6
External debt (percent of GDP, end-period)	19.1	17.9	18.4	21.2	24.8	25.9
Of which: Short-term debt 8/	6.6	7.0	7.4	8.9	10.5	10.7
Ratio of gross reserves to short-term debt (end-period) 8/	3.1	2.6	2.1	1.8	1.5	1.5
Debt service ratio 9/	5.0	5.1	5.8	4.2	5.6	5.4
Real effective exchange rate						
(based on annual average level)	8.0	11.6	-3.4	-2.4	...	...
Exchange rate (rupee/U.S. dollar, end-period) 5/	45.5	45.0	50.3	54.4	61.7	...

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

1/ Data are for April–March fiscal years.

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

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

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

5/ For 2013/14, as of December 5, 2013.

6/ On balance of payments basis.

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

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

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

**Statement by Rakesh Mohan, Executive Director for India  
and Janak Raj, Senior Advisor  
January 27, 2014**

1. On behalf of our authorities, we would like to thank staff for a thoughtful, comprehensive and balanced assessment of recent macroeconomic and financial sector developments in India and the evolving outlook. The report reflects the constructive and candid discussions that the Mission had with our authorities. Our authorities broadly share the staff's assessment.
2. India was impacted by the turmoil in the global financial markets on the back of tapering concerns in mid-2013. With a swift and decisive policy response, India was able to minimize the fallout on the real economy and maintain financial stability. The authorities acted to contain the current account deficit significantly, which is expected to be financed comfortably through sustainable capital flows. The fiscal deficit has also been reduced and our authorities are committed to pursuing the path of fiscal consolidation. The country continues to face a challenging domestic macroeconomic situation as growth has slowed down while inflation remains elevated. However, supply side pressures are easing due to the good monsoon during 2013-14.
3. Our authorities are determined to tame inflation, revive the growth impulses in the short run and put the economy back on a high growth trajectory over the medium term.

**Recent Macroeconomic Developments**

*GDP Growth and Short-term Outlook*

4. GDP growth picked up, though modestly, to 4.8 per cent in Q2 (July-September) of the fiscal year 2013-14 (the Indian fiscal year is from April to March). Growth in the first half of the fiscal year has been placed at 4.6 per cent. This is indeed disappointing when seen against India's growth record averaging around 8 per cent in the previous 10 years. However, indications are that the growth has bottomed out and our authorities expect it to be better in the second half on account of rebound in agriculture and improved export performance. The early and good monsoon will have a positive impact on rural demand, besides boosting hydro electricity generation. A fuller recovery is likely to start taking shape towards the end of the fiscal year when the recent measures initiated to clear the logjam constraining economic activity and investment work through the various inter-sectoral linkages in the economy. India's exports during 2013-14 are expected to grow in double digits, benefiting from the improved global growth prospects. The market sentiment has also improved, which is reflected in a sharp rise in stock markets. The Reserve Bank of India has projected GDP growth at 5 per cent for 2013-14.
5. The near term outlook beyond the current year is expected to improve on account of several factors. Many of the constraints to growth such as bottlenecks in project implementation, shortage of coal and iron ore, and delay in environmental and regulatory clearances are being actively addressed. The Cabinet Committee on Investment (CCI) has

cleared projects amounting to about 5 per cent of GDP. Most of the liquidity tightening measures taken during July-August 2013 in the wake of financial markets turbulence, which possibly had some impact on growth, have by and large been rolled back. All these developments should have a positive impact on the near term outlook.

6. One data issue has had an impact on ongoing growth estimation. Contemporaneous estimates of industrial production are dependent on the Index of Industrial Production (IIP). The preliminary data from this index have, in recent years, been found to underestimate industrial growth as exhibited by the more comprehensive Annual Survey of Industries (ASI), and hence, overall GDP growth. Whereas the IIP is compiled contemporaneously on a monthly basis, the ASI is an annual survey whose results become available with a lag. For instance, the results from the comprehensive ASI, which have now become available for 2011-12, suggest that industrial production increased by over 10 per cent as compared with the preliminary data indicating a growth of 3 per cent. Likewise, industrial production based on ASI during 2010-11 and 2009-10 increased by around 13 per cent and 10 per cent respectively as compared with the IIP estimates of 8 per cent and 5 per cent, respectively. Consequently, the GDP estimates for 2009-10 and 2010-2011 were revised - from 7.2 per cent to 8.6 per cent for 2009-10 and from 8.6 per cent to 9.3 per cent for 2010-11. Our authorities, therefore, believe that final GDP growth estimate for 2011-12 and following years will also be higher than the current estimates.

7. The World Bank in its recently released Global Economic Prospects (GEP) projects India's GDP growth for 2014-15 at 6.2 per cent vis-a-vis 5.4 per cent by the IMF in its January 2014 WEO Update as also in the 2014 Article IV Report. The IMF's WEO and World Bank's GEP estimates for almost all large countries are similar, except for India. Also, as per the projections of GEP, India will see the strongest recovery among major developing economies between 2013-16.

### *Inflation*

8. Elevated and persistent inflation remains a cause of serious concern. While wholesale price inflation has exhibited some moderation, retail inflation, which is dominated by food items, has continued to remain high. To contain inflation and anchor inflation expectations, the Reserve Bank of India (RBI) raised the policy repo rate by 50 basis points during August-October 2013 even when growth had slowed down. However, the RBI decided to pause in December 2013 to avoid over-tightening given a weak state of the economy and the significant output gap. It is comforting that most recent data suggest moderation in both wholesale and retail inflation. As supply pressures ease, and supply management improves, food inflation is expected to moderate further.

9. With the availability of the new all India consumer price index (CPI), the Reserve Bank is now endeavoring to move the dialogue in favor of CPI as a part of its communication strategy. The Expert Committee to Revise and Strengthen the Monetary Policy Framework set up by the RBI, submitted its report recently. It has made many recommendations. These, among others, include the proposal that inflation should be the nominal anchor for RBI's

monetary policy framework. Consequently, it suggests that RBI should adopt the new CPI (combined) as the measure of the nominal anchor for policy communications.

### *Fiscal Policy*

10. As the elevated fiscal deficit posed a major challenge to the economy, our authorities have committed to reduce it in a calibrated manner and have taken some politically tough decisions. The government has persevered with regular monthly increases in diesel prices to reduce the diesel subsidies in a phased manner. The fiscal performance in 2012-13 was better as the actual gross fiscal deficit declined to 4.9 per cent of GDP in 2012-13 as against the budgeted level of 5.1 per cent. For 2013-14, our authorities have budgeted the gross fiscal deficit at 4.8 per cent of GDP. Our authorities remain committed to contain the gross fiscal deficit to the budgeted level.

11. The Unique Identification Number (UID) or *Aadhar* is expected to avoid leakages and hence savings on subsidies. So far, over 400 million Indians have been issued *Aadhar* numbers. Over 23 million bank accounts have been linked to *Aadhar* numbers.

12. The fiscal implications of the *Food Security Act* entail an incremental budgetary allocation of Rs 100 billion in budget estimates (BE) for 2013-14, which is the first year of its implementation. The legislation came into effect during the current year, hence only a partial roll out could be put in effect. The food subsidy costs calculations in the Report assume full implementation in the entire country in the current year. For this to happen the State Governments need to adopt it and they also have to prepare the implementation mechanism. The Central Government would be providing adequate funds in a calibrated manner depending upon field level requirements. Presently, it is estimated that the FY 2014-15 requirement would be limited to Rs 1,200 billion, as compared with the full estimated food subsidy of Rs 900 billion in 2013-14.

### **Monetary and Exchange Rate Policies**

13. India's forex market came under pressure during May-August 2013 on account of capital outflows following the talk of tapering of quantitative easing. The forex market has since stabilized. As a result, most of the measures taken to stabilize the forex market have been rolled back. Responding to the various policy measures taken by the authorities to contain gold imports and improved export performance, the current account deficit narrowed down sharply to 1.2 per cent of GDP in Q2 of 2013-14 from 4.9 per cent of GDP in Q1 of 2013-14 and 5.0 per cent of GDP in Q2 of 2012-13. Our authorities believe that the CAD in 2013-14 will be less than the staff estimate of US \$ 61 billion (3.3 per cent of GDP) for 2013-14. The recent narrowing of the trade deficit should bring the CAD to a more sustainable level, i.e., less than US \$ 50 billion (less than 3 per cent of GDP) for the year as a whole.

14. In addition to containing the current account deficit, efforts have also been made to make the Indian economy more resilient by building buffers. Foreign exchange reserves have

been replenished by mobilizing US \$ 34 billion by way of non-resident Indian (NRI) deposits and bank borrowings in the international market. India's foreign exchange reserves, now at US \$ 292 billion, are comfortable in terms of various reserve adequacy criteria. While India may still be vulnerable to debt outflows on account of disorderly exit from quantitative easing by major central banks, this risk has been mitigated due to the containment of the current account deficit, reduction in the stock of the volatile component of capital flows, and an increase in foreign exchange reserves. Therefore, India is now in a much better position to deal with capital outflows should they take place. The enhanced currency swap arrangement with Japan for US \$ 50 billion provides India an additional buffer to deal with any potential external sector shock.

15. It needs to be recognized that bulk of the outflows by Foreign Institutional Investors (FIIs) of over US \$ 10 billion during June-August 2013 were of debt, out of a debt stock of US\$ 37 billion (as at end-May 2013). Equity portfolio outflows were much lower at US \$ 3.8 billion, out of a stock of US \$ 141 billion (as at end-May 2013). Significantly, equity outflows have been more than offset by large inflows in the subsequent period. In the past five years, foreign institutional investors have invested over US\$ 90 billion in the equity market. FDI flows to India have also remained stable in the recent period. This clearly suggests that long-term investors continue to have faith in India's growth prospects, and it is debt investors who are more fickle. This observation has relevance for the general IMF advice related to the opening of debt flows.

### **Financial Sector**

16. India's banking sector continues to be sound and healthy. Although NPLs of the banking sector have risen in the recent period, they still remain at a manageable level. Moreover, banks are maintaining adequate provisions. In order to ensure that NPLs do not grow further, banks have been advised to put in place a robust mechanism for early detection of signs of distress. Banks in India remain adequately capitalized. The stress tests conducted by the IMF assume that 45 per cent of all restructured advances would turn into NPAs. This assumption is unrealistic as the past historical average is at around 15 per cent. The stress scenario should not only be severe but also plausible. Similarly, the restructured to substandard NPA category conversion should attract the specific provisioning requirement as applicable to sub-standard assets instead of average provisioning of 60 per cent assumed by staff. Therefore, our authorities feel that the RBI's approach whereby 30 per cent of restructured assets turn into NPAs, which is twice the historical average, is conservative enough. Based on this assumption, the capital needs of banks will be significantly lower.

17. Concerns have been expressed regarding the treatment of restructured assets. The RBI has announced that asset classification/provisioning relaxations in respect of restructured assets will be phased out by April 1, 2015. As a prudential measure, banks are now also required to have capital and provisioning requirements for their exposures to entities with unhedged foreign currency exposure.

18. Staff has indicated that the vulnerability of the banking sector is aggravated by concentration risk: their report mentions that banking sector loans to India's ten largest

conglomerates account for almost 100 per cent of banks' net worth. The source of this market sensitive information is not the RBI. Therefore, one is not sure as to how much reliance can be placed on the inference drawn based on this information, which is not in the public domain. In any case, such a number becomes relevant only under the premise of correlated default. However, most of the large corporates are well diversified as a result of which they are in a better position to face the business cycle swings.

19. Several measures have been initiated to strengthen the regulatory and supervisory framework of banks. The Basel III capital regulation has been implemented in India from April 1, 2013 in phases. Additional capital requirements on account of Basel III, as is also estimated by staff, are likely to be manageable. It may be noted that in order to ensure that the public ownership of banks does not in any way hamper the growth of public sector banks, our authorities have capitalized public sector banks to the extent of Rs. 477 billion over last five years and another Rs. 140 billion will be infused during 2013-14.

### **Financial Inclusion**

20. The spread of financial inclusion among the uncovered segments of households and businesses has been a major policy objective for a long time. The Reserve Bank is examining the recommendations of the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households, which submitted its report recently.

### **Structural Reforms**

21. To raise the long-term growth potential of the economy, our authorities have introduced several structural reforms. The projects cleared by the CCI, as alluded to earlier, should improve the overall investment climate. We have moved a step closer to the introduction of the Goods and Services Tax with the Ministry of Finance having accepted all the recommendations of the Parliament Standing Committee on Finance. Some long-pending bills in the Parliament have been passed. FDI policy has been liberalized. The investment policy regime has been improved across a number of sectors. New land policy guidelines have been formulated for 12 major ports in the country that will help them to undertake various development projects. Construction work on the railways' dedicated freight corridor has been initiated. To encourage financial savings by the household sector, Inflation Index Bonds (IIB) have been introduced. The National Transport Development Policy Committee (NTDPC) set by the Government is likely to submit its report shortly. This should pave the way for wide-ranging reforms in the transport sector.

### **Medium-term Prospects**

22. Notwithstanding the recent growth slowdown, India's long-term productive capacity and potential have not been much affected. It is only some supply bottlenecks that have temporarily affected the investment activity. These bottlenecks as alluded to earlier have been addressed to a significant extent. Once investment activity revives, India should be able to quickly regain its long-term growth potential. We reiterate that staff's estimates of potential growth seem to focus on the very near-term growth prospects of the economy.

They, therefore, vary annually and are sensitive to choice of methodology. Potential growth is a medium to longer-term concept. As such, potential growth reflects underlying structural trends rather than cyclical variations and year-to-year shifts and events.

## **Conclusion**

23. The recent period has been challenging for the Indian economy. Even as our authorities were grappling with slow growth and persistent inflation, our economy, like many other emerging market economies, had to contend with the turbulence in financial markets. In particular, India's currency came under pressure due to its high current account deficit. However, through deft handling, India was able to quickly restore stability in the forex market. India's elevated current account deficit has been addressed, while the fiscal deficit is on a downward path. Swift and quick policy response during difficult times has been the hallmark of India's policy making. Our authorities, however, have been conscious of the several challenges that remain. Elevated and persistent inflation continues to pose a major macroeconomic challenge. Another major challenge is to revive investment activity and put the Indian economy back on a high growth trajectory.