

**India: 2012 Article IV Consultation—Staff Report; Staff Statement and Supplements; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for India**

Under Article IV of the IMF’s Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with India, the following documents have been released and are included in this package:

- The staff report for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on January 19, 2012, with the officials of India on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 22, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A supplement containing a Debt Sustainability Analysis
- A staff statement of March 9, 2012
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 9, 2012 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for India.

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# INDIA

## STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

February 22, 2012

### KEY ISSUES

**Outlook and Risks:** Growth remains relatively high, but various factors, including the unsettled global outlook and slow government decision-making, have weighed on investment. Inflation has moderated, leading the RBI to pause monetary tightening, but remains elevated. The slow pace of fiscal consolidation has added to demand pressures. Growth is projected at 7 percent for 2011/12 and 2012/13, while risks – from slow reform efforts, high and volatile inflation, and the global situation – remain on the downside.

**Short-Term Demand Management Policies:** Base effects have brought inflation down in recent months, but pressures including from high expectations, depreciation, and little excess capacity suggest that rate cuts are premature. The 2011/12 budget target is likely to be exceeded; returning to fiscal consolidation will require subsidy reform which the government has long committed to, as well as tax reforms, which have been delayed.

**Policies to Revive Investment and Inclusive Growth:** Ensuring sustainable growth will require reinvigorating the structural agenda, rather than relying on monetary and fiscal stimulus. Measures to facilitate infrastructure investment, reform the financial sector and labor markets, and address agricultural productivity and skills mismatches stand out. The FSAP concluded that India's financial system is broadly stable, but noted scope for some further improvements in stability and developmental areas. Reconstituting fiscal space and reorienting expenditure toward capital and social areas are vital to make growth more inclusive, and also to reduce financial restrictions (which in turn would boost growth).

**Spillovers from External Risks:** While external risks are manageable in the baseline, a protracted downturn in advanced economies could have a sizable impact on India's growth. Advanced economies' bank deleveraging is underway, which so far has been offset by banks from the region. But a sudden stop of capital inflows would complicate the financing of the current account deficit. Also, India's large corporations present an important potential channel of contagion.

Approved By  
**Masahiko Takeda and  
 Tamim Bayoumi**

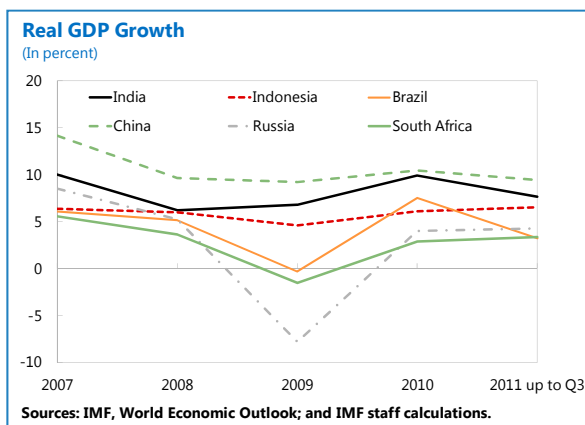
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 Mission dates: January 5-19, 2012

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## CONTEXT

**1. India's growth remains one of the highest in the world, but a range of factors have weighed it down.** Following a rapid recovery after the global financial crisis (GFC), the economy has slowed more than most other major emerging markets (EMs), as concerns about governance and policy uncertainty have dampened investment. Consumption, particularly in rural areas, and exports, with increasing geographical destination diversity and sophistication, have been bright spots. At the same time, inflation is elevated, and its recent moderation is primarily due to base effects. While monetary policy has been tightened, the fiscal deficit remains high.



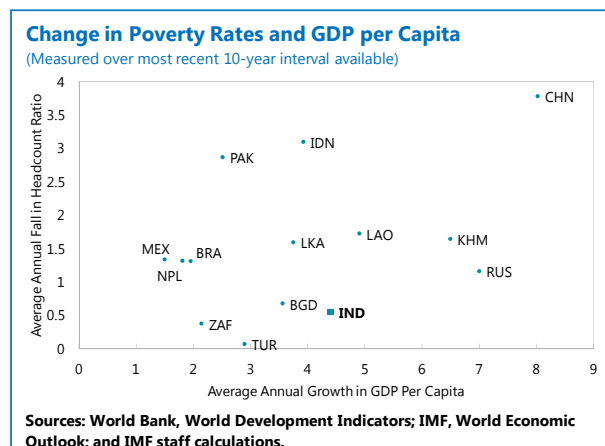
**2. The unsettled global outlook has added to policy challenges.** After the boom in capital inflows in 2010/11, rising global risk aversion has reduced the flow of capital. The rupee depreciated the most among major

Asian currencies in 2011, partly due to India's current account deficit. Concerns about global growth have harmed investor sentiment and deleveraging by advanced economy banks has raised the cost of external finance.

**3. The authorities have a broad reform agenda, which has been implemented only slowly.** Progress has been made on financial reforms—notably the liberalization of saving deposit rates and the continued opening of the domestic debt market to foreign investors—and FDI in single brand retail has been liberalized. However, important legislation to reform taxation and facilitate infrastructure building is awaiting approval. Many investors have been disappointed by the pace of reform of the present government coalition, which had been expected to accelerate implementation, and more recently have become concerned about slower government decision-making following high-profile governance scandals and increased civil activism. The 2012/13 Budget and the 12<sup>th</sup> Plan (2012/13-2017/18) are expected to propose a broad agenda for further reform, but with general elections due in 2014, the window for passing difficult measures may be short. The 12<sup>th</sup> Plan Approach Paper rightly emphasizes power, water, and agriculture investment, and better governance, health, and education.

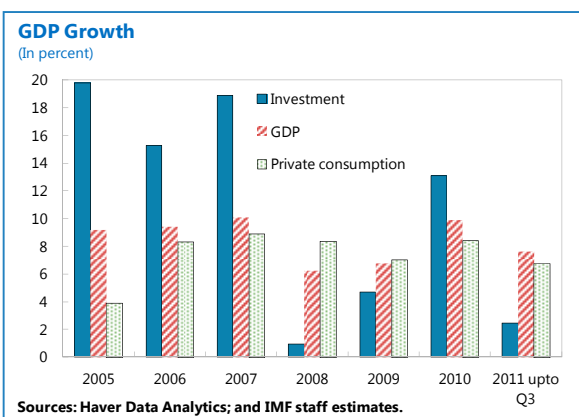
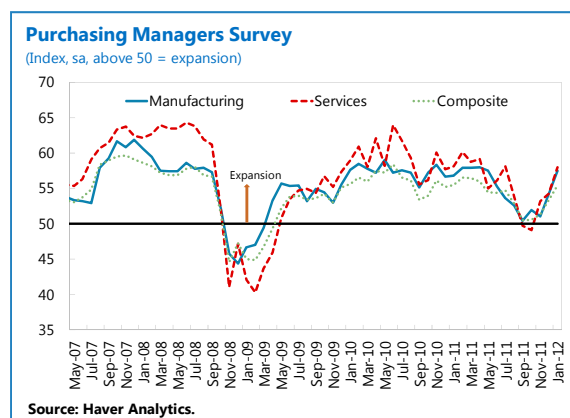
**4. Making India’s rapid growth more inclusive is an important goal.** Around 1/3 of the population lives below the government’s new poverty line, down from 45 percent in 1993/1994.<sup>1</sup> This is an important achievement, though poverty reduction has been somewhat slow compared to other countries (Box 1).

<sup>1</sup> Tentative estimates for 2009/10 reported in Montek S. Ahluwalia (2011) “Prospects and Policy Challenges in the Twelfth Plan”, Planning Commission.



## THE CONJUNCTURE AND OUTLOOK

**5. Weak investment is at the core of the recent growth slowdown.** Investment, which reached 38 percent of GDP before the GFC, buoyed growth to almost 9 percent, the authorities’ often-stated goal, and likely also the 12<sup>th</sup> Plan target. Since the GFC, corporate investment has fallen. The difficulty of forecasting returns in a high-inflation environment, governance concerns, heightened global uncertainty, rising funding costs, and structural rigidities have all played a part (Box 2). Recent high frequency activity indicators (manufacturing and services PMIs)



have started to recover, but it is unclear whether the improvement will extend to investment (Figure 1).

**6. Consumption and exports have been robust.** Disposable income (wage) growth has continued to underpin private consumption, especially in rural areas. Exports have been strong during the recovery from the GFC and have generally benefitted from geographical and product diversification (Box 3). However, some moderation in consumption became visible in 2011Q3 as elevated inflation has

## BOX 1. POVERTY AND INCOME INEQUALITY IN INDIA<sup>1</sup>

**1. Despite high growth, poverty in India remains high.** Two prominent Indian economists recently stated that “[India’s] growth record is very impressive...[b]ut there has also been a failure to ensure that rapid growth translates into better living conditions for the Indian people.”<sup>2</sup> While poverty has been falling, the share of the population living below the World Bank’s international \$1-a-day poverty line remains high (Table) and income inequality has risen. Progress on social indicators has also been slow: access to education

Indicators of Poverty and Inequality					
	Percentage of Population Undernourished	Net Enrollment in Primary Education (Girls)	Infant Mortality per 1000 Live Births	Percentage of population earning below \$1 (PPP) per day 1/	GINI Coefficient
<b>India</b>	<b>19.0</b>	<b>93.6</b>	<b>50.0</b>	<b>41.6</b>	<b>36.8</b>
Bangladesh	26.0	93.1	40.0	49.6	31.0
Nepal	17.0	n.a.	43.0	55.1	47.3
Sri Lanka	20.0	95.6	15.0	7.0	40.3
<b>Average: South Asia</b>	<b>21.0</b>	<b>94.4</b>	<b>32.7</b>	<b>37.2</b>	<b>39.5</b>
China	10.0	n.a.	17.0	15.9	41.5
Indonesia	13.0	n.a.	28.0	18.7	36.8
Malaysia	5.0	94.0	6.0	0.0	46.2
Philippines	13.0	93.2	24.0	22.6	44.0
Thailand	16.0	89.4	12.0	10.8	53.6
Vietnam	11.0	n.a.	19.0	13.1	37.6
<b>Average: East and SE Asia</b>	<b>11.3</b>	<b>92.2</b>	<b>17.7</b>	<b>13.5</b>	<b>43.3</b>
Brazil	6.0	94.3	18.0	3.8	53.9
Mexico	5.0	99.6	15.0	3.4	51.7
Russian Federation	5.0	94.6	10.0	0.0	42.3
South Africa	5.0	90.3	43.0	17.4	57.8
<b>Average: selected EMs</b>	<b>5.3</b>	<b>94.7</b>	<b>21.5</b>	<b>4.7</b>	<b>51.4</b>

1/ Adjusted for price and currency shifts, now comparable in India to US\$1.25 a day.  
Source: UNStats and World Bank. Data provided are most recent available since 2005.

has been broadened but malnutrition remains a problem, and infant mortality remains very high.

**2. Ensuring a more stable macroeconomic environment would lay the groundwork for reducing poverty and inequality.** There is an extensive literature on how inflation can be particularly damaging to the poor, who are unable to insure against changes in prices. Recent Fund research further divides inflation into food and nonfood inflation, showing that higher nonfood inflation is generally associated with higher income inequality, while higher food inflation is associated with marginally lower inequality, both across countries and among Indian states.<sup>3</sup> Fiscal consolidation, by reducing demand pressures, would also contribute to macro stability.

**3. But structural measures will be essential in the long run.** The 12<sup>th</sup> Plan will present measures to improve outcomes in health, education and agriculture, improve infrastructure to reduce regional disparities and facilitate communication, and to improve governance to raise the quality of public services. Beyond this, reforming expenditure to more accurately target subsidies to the poor and making progress on the financial inclusion agenda proposed by the government and endorsed by the recent FSAP mission would also help make growth more inclusive.

<sup>1</sup> Prepared by James P. Walsh (APD).

<sup>2</sup> Drèze, J. and Amartya Sen, “Putting Growth In Its Place,” *Outlook India*, Nov. 14, 2011.

<sup>3</sup> Based on Walsh, James P. and Jiangyan Yu, 2012, “Inflation and Income Inequality: Is Food Inflation Different?” IMF Working Paper, forthcoming.

## BOX 2. CORPORATE INVESTMENT IN INDIA<sup>1</sup>

### 1. While investment was the main driver of growth before the global financial crisis, it has been lackluster since then.

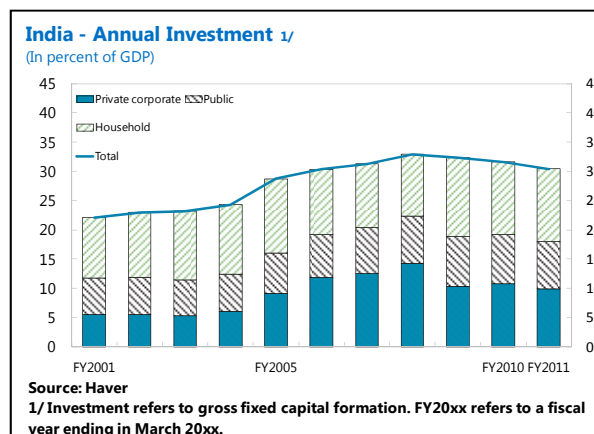
Strong corporate investment drove the overall increase in investment, but it has slowed to 10 percent of GDP from 14 percent before the crisis. More recently, the quarterly growth of investment (gross fixed capital formation) has fallen to about -0.6 percent on average in the first three quarters in 2011, compared to an average of nearly 3 percent between 2000 and 2007. High frequency data suggest that this reflects weak corporate investment.

### 2. Both macroeconomic and structural factors are responsible for recent weak corporate investment.

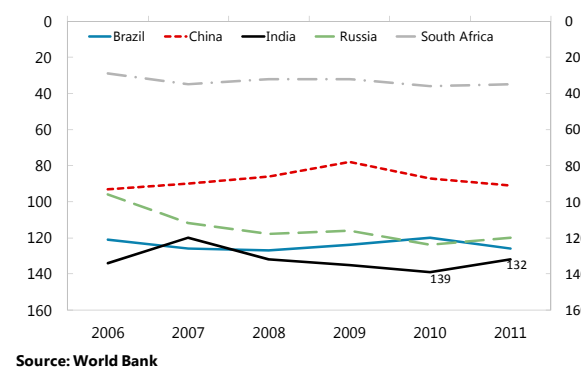
The high and volatile inflation rate and heightened global uncertainty appear to have depressed corporate investment since the global financial crisis. Monetary tightening since early 2010 may have affected it at the margin as well. However, since late 2010, quarterly investment has fallen short of levels predicted by these standard macroeconomic variables (see figure),<sup>2</sup> which suggests that the recent low investment may also be due to structural factors, such as the business environment and governance.

### 3. Staff's analysis of firm-level micro panel data shows that profitability, liquidity, and leverage are key determinants of corporate investment in India.

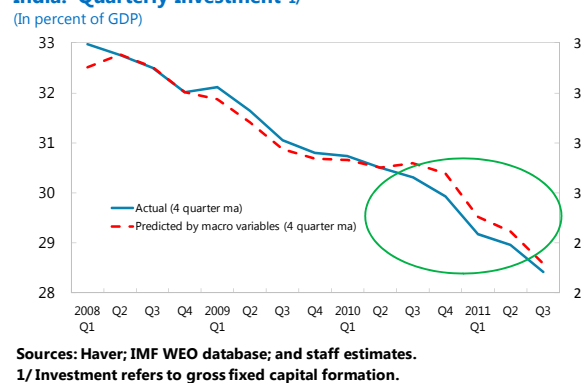
The significance of liquidity suggests that there remains room for improving financial access.



### Headline Doing Business Rankings



### India: Quarterly Investment 1/



<sup>1</sup> Based on Tokuoka, K., 2012, "Does the Business Environment Affect Corporate Investment in India?," IMF Working Paper, forthcoming.

<sup>2</sup> Only data on overall investment (gross fixed capital formation) are available on a quarterly basis. This limitation needs to be kept in mind in interpreting the results.

## BOX 2. CORPORATE INVESTMENT IN INDIA (continued)

**4. India has substantial room for improving its business environment to boost corporate profitability, which is a key determinant of corporate investment.** According to the World Economic Forum, India's global competitiveness fell to 56<sup>th</sup> place in 2011 from 49<sup>th</sup> in 2009, reflecting weakening institutions (e.g., transparency of government decision making) and the relatively slow pace of infrastructure improvement. The World Bank has ranked India at 132<sup>nd</sup> out of 183 countries in the world (up from 139<sup>th</sup> in 2010) in terms of ease of doing business. In this survey, India is ranked at 166<sup>th</sup> in starting a business, 97<sup>th</sup> in registering property, and 182<sup>nd</sup> in enforcing contracts. These rankings indicate that India could do more to enhance corporate sector profitability by reducing the costs of doing business and improving institutions. In addition, according to the World Bank, there are large differences in costs of doing business across Indian cities, meaning that many cities in India can learn from its best-performing cities.

**5. Micro empirical analysis confirms that lowering business costs could enhance corporate profitability.** Moreover, for exporters, lowering costs to export appears to raise profitability, indicating that cutting such costs by improving infrastructure, especially transport, would be beneficial. According to staff estimates, reducing the average of each cost of doing business to the lowest among Indian cities is estimated to boost corporate investment by 3-13½ percent through raising profitability (see table).

**Table. Estimated Aggregate Impact of Reducing Costs of Doing Business**

	Reducing the Average of Each Cost to Lowest		
Change in aggregate corporate investment (in percent)	3.1	-	13.5
Costs of starting business	0.6	-	1.8
Costs of registering property	0.3	-	1.9
Costs of enforcing contracts	1.0	-	4.0
Costs to export	1.2	-	5.8
Direct demand impact on GDP (in percent of GDP)	0.3	-	1.5
Costs of starting business	0.1	-	0.2
Costs of registering property	0.0	-	0.2
Costs of enforcing contracts	0.1	-	0.4
Costs to export	0.1	-	0.6



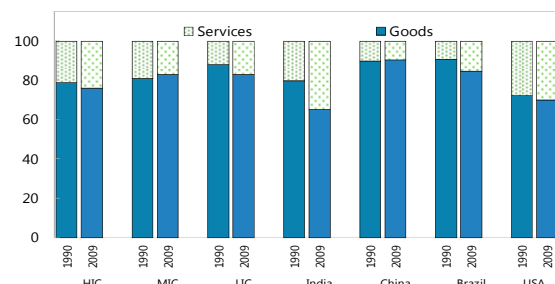
### BOX 3. INDIA'S EXPORTS: THEIR EVOLUTION AND FUTURE PROSPECTS<sup>1</sup>

**The composition of India's exports is unique.** The share of services exports, which has reached 35 percent, is higher than in advanced countries, but the share of manufacturing exports in total goods exports is still low. While services exports have a high technology content and high-value added, the goods and manufacturing exports are still dominated by relatively low-tech and low-value added products, though there is a clear shift away from traditional exports (e.g. textiles, gems, and leather products) towards medium- and high-tech products (e.g. engineering goods). Based on an index of export sophistication developed by Anand et al. (2012),<sup>2</sup> Indian services exports are more sophisticated relative to its income level. However, India's goods export sophistication has remained below the average sophistication level of Asia, and it is lower than China's and Brazil's.

**The evolution of exports is expected to help India increase sophistication and diversification further and should benefit India through reallocation of resources and catch up in productivity.** The sophistication and diversification of Indian exports have reached a threshold that will enable them to acquire skills and assets needed to move closer to the production possibility frontier. Growth is likely to benefit from knowledge spillovers. High exports sophistication, particularly of services, is likely to support growth. Increasing the sophistication of manufacturing exports would result in higher productivity and reallocation gains similar to those seen in the services sector. Going forward, India could benefit from realizing exports with new regions: even though exports to emerging and developing economies have increased, the potential to increase them further is substantial.

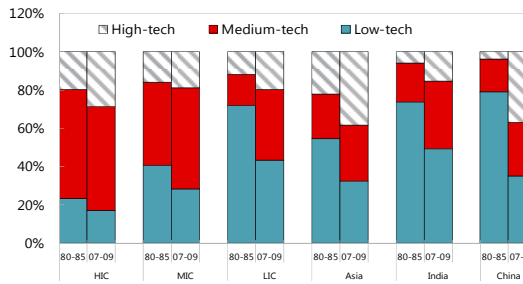
**However, realizing these benefits will require trade reforms, investment in infrastructure, health and education, and labor market reforms.** The key trade reform areas are reducing trade restrictiveness and improving trade facilitation and infrastructure. India's weighted average tariff is high relative to other G20 economies. Also, India scores much below comparator Asian economies on the Overall Logistic Performance Index. A substantial investment in infrastructure, health, and education (both basic and technical) will be needed to sustain and increase sophistication. In addition, labor law reforms will be necessary to realize efficiency and productivity gains in manufacturing.

**Share of Services Exports**  
(In percent of total exports)



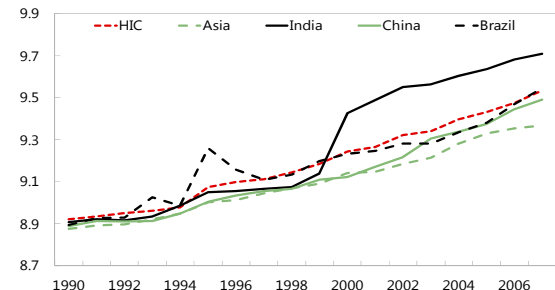
Sources: Balance of Payments, IMF.

**Share of High-tech Manufacturing Exports**  
(In percent of total manufacturing exports)



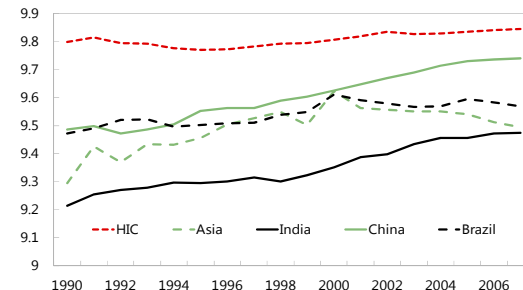
Sources: IMF staff estimates.

**Sophistication of Services Exports**  
(Non resource rich countries)



Sources: IMF staff estimates.

**Sophistication of Goods Exports**  
(Non resource rich countries)



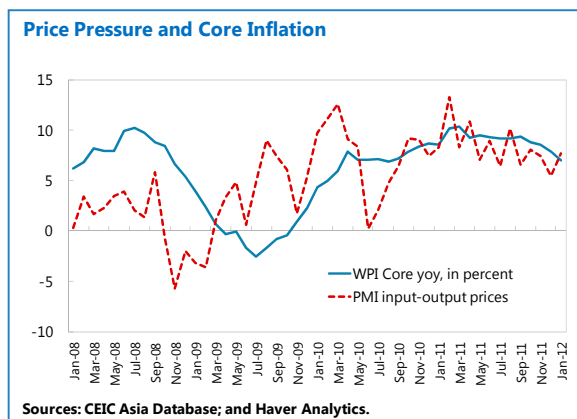
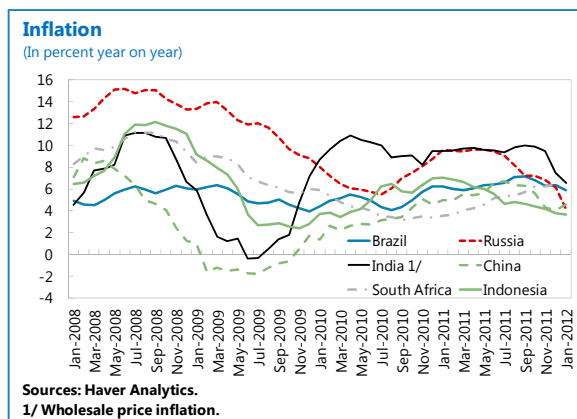
Sources: IMF staff estimates.

<sup>1</sup> Based on Anand, R., 2012, "Indian Exports: Their Evolution and Future Prospects," IMF Working Paper, forthcoming.

<sup>2</sup> Anand, R., S. Mishra, and N. Spatafora, 2012, "Structural Transformation and the Sophistication of Production," forthcoming IMF Working Paper (Washington: International Monetary Fund).

eroded purchasing power and interest rates have risen. Exports have also softened.

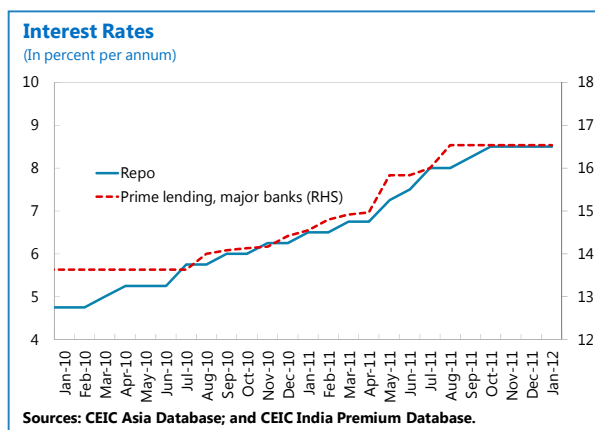
**7. Inflation is moderating, but remains elevated compared to other EMs and is generalized.** Core and headline inflation have stayed above historical averages and the RBI's stated objectives. Pricing power in manufacturing, measured by the difference



between PMI input and output prices, is still strong. While profit margins may continue to drop, inflation pressures could take time to ease as there is little or no excess capacity. Nominal wage growth has outpaced inflation since 2010. Expectations have drifted upwards, in part because consumer price inflation, which weighs food heavily, has been above 7 percent for almost four years. Rising incomes,

particularly in rural areas, are leading to higher food demand and shifting its composition toward proteins and away from grains, fueling food price pressures. Large increases in agricultural support prices and the indexation of rural relief wages have also contributed. WPI inflation fell to 6.6 percent in January 2012 and CPI inflation dropped to 6 1/2-8 1/2 in December 2011, mainly due to base effects on vegetable prices, while the inflation momentum is still at about 7 percent.

**8. After raising policy rates by 375 basis points over the last two years, the RBI has paused, citing rising growth risks.** The call money rate measured in real terms, after being negative for two years, has now risen by about 500 basis points and reached nearly 2 percent in January 2012. The authorities have also taken steps to improve monetary transmission by establishing the repo rate as the main policy rate, liberalizing savings deposit rates, linking interest rates on small savings to market rates, and through the base rate reform (Figure 2). These measures and the shift to a liquidity deficit in the money market have led to increased pass-through from the repo rate to lending rates. However, the depreciation of the NEER since July (about 8 percent) has partly offset interest rate hikes. While the RBI in January 2012 cut cash reserve requirements by 50 basis points citing tighter-than-expected liquidity, it added that policy rates will not be cut until inflation has moderated sustainably.



**9. The fiscal deficit remains high, adding to demand pressures.** The modest decline in the deficit to GDP ratio in 2010/11 resulted mostly from one-off measures (Figure 3). With limited progress on subsidy reforms and oil prices remaining firm, the 2011/12 deficit target is likely to exceed the target by about 1 percent of GDP, despite a slower pace of capital spending compared with previous years. A midyear rise in fuel prices mitigated spending pressures, but the subsidy bill is still likely to exceed the budget by a substantial amount. Corporate tax revenues have been hit by the slowing economy and measures to broaden the base of services taxation were partly offset by cutting indirect taxes on fuels. Public debt declined to 67 percent of GDP in March 2011, due to high nominal GDP growth.

**10. Growth is projected at about 7 percent for 2011/12 and 2012/13, with inflation forecast to remain above the RBI's comfort zone.** Investment is anticipated to pick up modestly from the slump recorded in 2011Q3, as indicators of capital goods

production have started to stabilize. Consumption should remain robust, but exports are cooling. Over the medium term, potential output growth is estimated at around 7.5-8 percent, assuming faster government project approvals.<sup>2</sup> Inflation is projected at 6¾ percent in March 2012, but to stay at around 7 percent for the rest of 2012, compared to the RBI's 4-4.5 percent near-term, and 3 percent medium-term, objectives. The current account deficit is projected to widen slightly to 2.8 percent of GDP, as exports soften along with the global economy and oil prices remain high.

**11. Growth risks are to the downside.** The main domestic risk is a further weakening of private investment if government approvals of projects do not accelerate, reform efforts are not reinvigorated, and inflation remains high and volatile (Box 4). At the same time, external risks continue to be elevated as Euro area growth could underperform and bank deleveraging could intensify even in the absence of a new full-fledged global financial crisis (discussed separately below).

#### Authorities' Views

**12. The authorities believe the Indian economy has passed the point of greatest concern with industrial activity turning up**

<sup>2</sup> Potential output estimates are based on a simple two-factor decomposition using the HP filter to calculate capital utilization, and direct application of the HP filter and an asymmetric band-pass filter to the seasonality adjusted market price GDP series.

**BOX 4. INDIA: RISK ASSESSMENT MATRIX<sup>1</sup>**

<b>Nature/Source of Threat</b>	<b>Likelihood</b>	<b>Expected Impact on Economy</b>
<b>Continued investment slowdown</b>	<i>Staff assessment: MEDIUM</i> Strong investment growth will require speeding up government decision making and approvals, as well as substantial progress on the reform agenda.	<i>Staff assessment: HIGH</i> Lower investment would reduce potential GDP growth, dimming India's long-term prospects. A continued slowdown would lead to rising NPAs (see attached FSSA) and other financial stresses, and would add to fiscal risks.
<b>Inflation remains high and volatile</b>	<i>Staff assessment: MEDIUM</i> Supply constraints could cause prices, especially of food items, to accelerate once base effects dissipate. Also, momentum indicators are mixed.	<i>Staff assessment: MEDIUM to HIGH</i> Should inflation rise again confidence in macroeconomic management could harm investment, while disinflation could require substantial monetary tightening, weighing on growth.
<b>Renewed global financial turmoil and prolonged slowdown in advanced economies<sup>2</sup></b>	<i>Staff assessment: MEDIUM</i> The global situation remains highly uncertain and volatile. India would be exposed to potential negative developments through trade and especially financial channels.	<i>Staff assessment: HIGH</i> Investment and confidence are already weak, and a deterioration in the global outlook would cause further damage, while a drying up of financial markets would complicate the financing of the current account deficit and cause severe domestic dislocation, at least in the short term. With less policy space than in 2008/09, it is unlikely that countercyclical policy could be as effective as during the GFC.
<b>Fiscal expansion</b>	<i>Staff assessment: MEDIUM</i> A large expansion of India's social programs without compensating measures could widen the fiscal deficit considerably.	<i>Staff assessment: MEDIUM</i> Crowding out could hurt investment, while microeconomic distortions from further market interventions could depress productivity. Interest rates would likely rise, but with a captive investor base the risk of a serious financing crisis is limited.

<sup>1</sup> A similar risk matrix in the FSSA elaborates on the risks to the financial sector.

<sup>2</sup> See Annex I.

**and inflation starting to ease.** They estimate growth to be between 7-7.5 percent in 2011/12 and expect that it will pick up in the second half of 2012/13. While taking note of the recent moderation of quarterly growth rates, the authorities expect investment to recover as financial conditions ease and domestic sentiment improves. The trade balance has widened slightly in 2011/12, but the recent depreciation of the rupee and the continued strength of Indian exports are expected to keep it contained. These factors, combined with continued strength in consumption, are expected to bring growth in 2012/13 back toward the trend range of 8-8½ percent, provided global financial risks do not materialize.

**13. External factors weigh more heavily in the authorities' assessment of the current situation, especially energy prices.** Further deleveraging by European banks may have limited direct impact but second order effects on Indian banks might materialize through

trade, finance and confidence channels. Since mid-2011, a deteriorating outlook in advanced economies has manifested in EMs, including India, through capital outflows, while commodity prices remain high. In 2008/09, sharply lower oil prices helped bring Indian inflation down, allowing for monetary easing while reducing the trade deficit. These beneficial effects have not occurred during the past year.

**14. The RBI stresses that vigilance continues to be warranted on inflation.**

Disinflation could be complicated by structural factors resurfacing as pressure on food prices, especially of protein items, as well as by weak government finances and adjustments to petroleum and coal prices, which remain significantly below international prices. Noting wage-price dynamics and expectations formation in India, the RBI remains concerned about inflation risks and will look out for a sustained moderation in inflation before lowering the policy rate.

## POLICY DISCUSSIONS

*The domestic conjuncture as well as external risks point to the need for structural reforms that can ease supply constraints and boost inclusive growth. The discussions focused on:*

1) short-term demand management policies

*that would contribute to lowering inflation; 2) policies and reforms that can facilitate investment; and 3) risks in the event of a new full-fledged global crisis.*

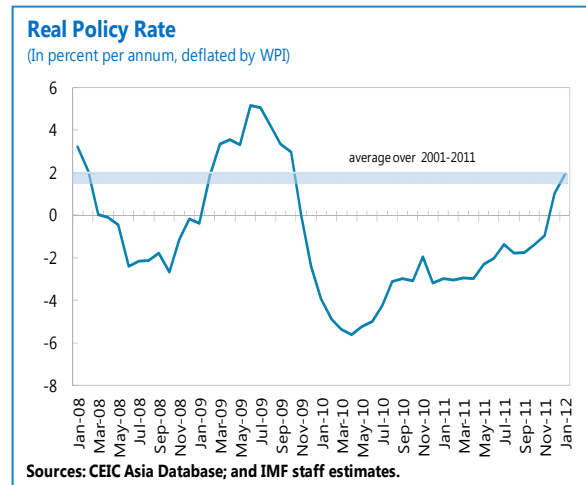
## A. Short-Term Demand Management Policies

**15. Continued disinflation is needed and inflation risks are still substantial.** RBI and staff analysis suggest that inflation beyond 5-6 percent is associated with lower growth (Box 5). Inflation and inflation volatility also harm investment and may have been an important reason for the decline in the household savings rate in 2010/11. Bringing inflation, particularly non-food inflation, down, can also improve income inequality (see Box 1). But as inflation has become highly persistent, disinflation may require output to remain below potential for an extended period of time. Base effects are expected to persist and keep inflation slightly below the RBI's end-March projection of 7 percent. This would bring the real repo rate toward its historical average of 1.5-2 percent and broadly in line with the level implied by a standard Taylor rule.<sup>3</sup> Nevertheless, given structural pressures on food prices, little or no excess capacity, high nominal wage growth, inflation expectations that have drifted upwards, and the rupee depreciation still to pass through completely, vigilance is required against the possibility that, after base effects wear off, inflation could rise again.

**16. Continuing to enhance the monetary policy framework could help anchor inflation expectations.** Forward

<sup>3</sup> Using the one-year-ahead forecast for inflation yields 8.5-8.75 percent compared to the current rate of 8.5 percent.

guidance could be provided by the RBI publishing rolling one-year ahead inflation forecasts. The RBI could also give more



weight to the CPI in policy formulation over WPI, as household inflation expectations are primarily driven by consumer prices, and also because CPI better reflects households' consumption patterns.

**17. With consolidation falling short of the 13<sup>th</sup> Finance Commission's (FC) roadmap, fiscal policy has not contributed sufficiently to disinflation and appears to be crowding out private spending.** The center's deficit is likely to decline by 0.2 percent of GDP in 2011/12, compared to the FC target of 0.9 percent. The lesser dependence of the states on corporate taxation means they may be less affected, but the slowdown may still push the general government deficit above the forecast 8.1 percent of GDP. Capital spending remains below FC targets, while subsidies have not been contained. Average interest rates on

### BOX 5. THE OUTPUT-INFLATION TRADE-OFF IN INDIA: IMPLICATIONS FOR DISINFLATION<sup>1</sup>

**1. The detrimental effects of high inflation on growth are well documented in the literature.**

For example, Khan and Senhadji (“Threshold Effects in the Relationship between Inflation and Growth,” IMF Working Paper 00/110, 2000) indicate that high inflation hurts growth, and identify different inflation levels for advanced (1-3 percent) and developing economies (7-11 percent) above which inflation begins to hurt growth.

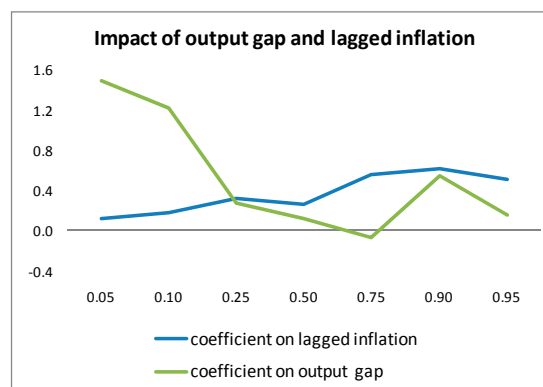
**2. Several papers have estimated that inflation beyond 5-6 percent is detrimental to growth in India.** Ahluwalia (“Prospects and Policy Challenges in the Twelfth Plan”, Economic and Political Weekly, May 2011) notes that inflation above 6 percent is “regressive and also distortionary, damaging both inclusion and growth”. Mohanty et al. (“Empirical Threshold in India: An Empirical Investigation”, RBI Working Paper 18/2011, 2011) find evidence of an inflation threshold for India in the order of 5.5 percent. Using quarterly data from 1996-2011, we also find evidence that puts the inflation threshold at 5-6 percent for India.

**3. Threshold analysis can also be used to shed light on the nature of the inflation-output tradeoff at different levels of inflation.** For this, we use a backward-looking Phillips curve (PC) model, and apply quantile regression which allows the estimated slope parameter to differ depending on the level of inflation. We also conduct standard OLS regressions to compare results. The estimated equation is given by:

$$Q_{\tau}(\pi_t) = \sum_{i=1}^p \beta_{i,\tau} \pi_{t-i} + \gamma_{\tau}(y_t - y_t^*) + \varepsilon_t$$

where  $\gamma$  is the slope of the PC and  $\tau$  refers to the  $\tau$  th quantile of the dependent variable (i.e., any particular level of inflation for which  $\gamma$  is to be estimated). Other controls are included, such as real oil prices.

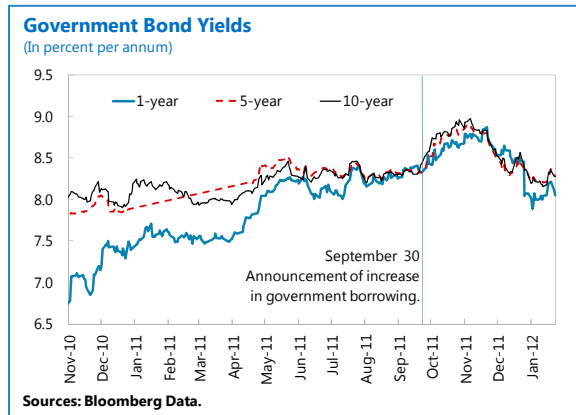
**4. The estimated Phillips curves confirm that the tradeoff between inflation and output differs at different levels of inflation.** The standard OLS regression shows that a 1 percentage point increase in the output gap leads to a 0.4 percentage point increase in inflation. This implies large disinflation costs; for instance, growth needs to be below potential by 2 percentage points (assuming unchanged potential growth of 7.8 percent) for inflation to drop by 1 percentage point. But more importantly, quantile regression estimates suggest that the cost of disinflation becomes larger at higher levels of inflation. In addition to the changing slope of the PC, inflation becomes more inertial at higher levels. This is consistent with recent anecdotal evidence that wage indexation has become more widespread and survey evidence showing that inflation expectations have become entrenched.



<sup>1</sup> Prepared by Roberto Guimarães (APD).



government debt have risen and the announcement in September 2011 of higher government market borrowing caused a jump in long-term interest rates, both indicating that crowding out is occurring, though the RBI's open market operations aimed at easing liquidity have subsequently lowered yields.



### Authorities' Views

**18. The authorities expect inflation to reach the March 2012 projection (7.0 percent), and show some further decline in 2012-13.** The authorities believe manufacturing inflation could soften, although momentum indicators remain flat, which along with favorable base effects will bring headline inflation down. The RBI also judges that the pass-through from rupee depreciation has already largely taken place, and notes that below-potential growth in 2012 would reduce firms' pricing power.

**19. The interest rate cycle has peaked, but not yet turned.** Tighter policy has successfully eased demand-side pressures and cooled growth, though tightening has been amplified by external shocks. The RBI

has clearly stated it has stopped raising policy rates, but whether rates are cut will depend on the future trajectory of inflation, global commodity prices, and the evolving fiscal situation. The RBI notes that in setting its policy rates, it could not yet let its guard down on inflation but balancing growth concerns would also become an important factor.

### 20. The RBI will continue to base its policy decisions on various price indices.

The RBI recognizes the importance of consumer price developments in setting policy. Accordingly, it closely monitors multiple consumer price indices classified on the basis of different economic groups that have been compiled since the early 1950s. However, as the national CPI was introduced only in 2011, the WPI remains the only established national price index. In addition, the higher weight of food in the CPI means its basket is likely to be less responsive to demand-management measures such as monetary policy. Therefore, the RBI will continue to use a multiple-indicator approach, looking at developments in WPI and CPIs, as well as various other indicators of inflation and economic activity.

**21. The authorities agree that the 2011/12 budget target is likely to be exceeded.** Noting that the buoyancy of indirect taxes was likely to compensate for the reduction in fuel taxation, the authorities anticipate that revenue shortfalls would be



minimal. Fertilizer and fuel subsidies have exceeded budget estimates, due to high global commodity prices, but these losses can be contained. The slow pace of fiscal consolidation has added to inflation challenges. Noting that long-term interest

rates did not react as strongly to the December 2011 announcement of additional borrowing as they did to the September announcement, the authorities believe that crowding out is not a pressing issue now.

## B. How to Revive Investment and Facilitate Inclusive Growth?

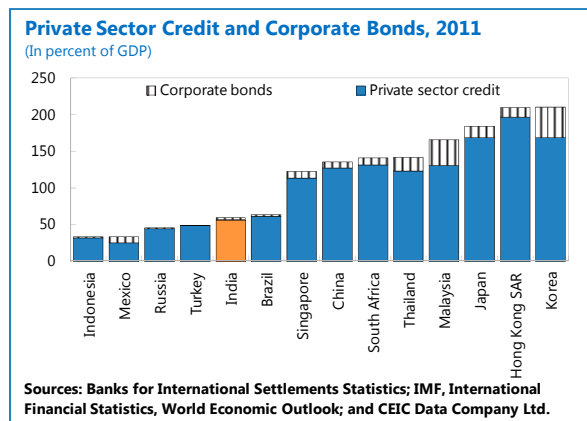
**22. Implementing structural reforms to revive investment is crucial for ensuring sustainable growth.** Persistently high inflation shows that supply constraints are binding. To lessen these constraints and reverse the slowdown, investment must rise. Alternatively, protracted weak investment would initially lower demand, but more worryingly, over time would reduce potential growth. Better infrastructure, more efficient provision of public services, less restrictive labor laws, and a larger manufacturing sector can all stimulate investment. On the other hand, demand management policies can only provide limited impetus to growth, given the high fiscal deficit and the continued need to bring inflation down.

**23. To reinvigorate investment, there are some key areas for focus.** Staff research shows that there is ample room for India's business environment to improve, indicating a high potential for structural reforms, and given wide variations across cities, India can learn from itself (see Box 2). Enhancing clarity and predictability of regulations, and accelerating approval processes under such regulations, is vital for reforms to bear tangible fruit. Also,

some of these measures are under the states' purview, and hence states' regulations and practices would also need to be adjusted. Key reform areas are:

- Infrastructure, including by simplifying permitting procedures and making contracts more enforceable, facilitating land acquisition and making it more predictable and equitable. Speeding up reforms in the power sector is an urgent priority, particularly through better allocation of domestic coal, bringing state electricity boards' finances on a sustainable footing, and reforming coal pricing and electricity tariffs.
- Financial markets, while developing rapidly, still retain important roadblocks to faster growth. Due to the predominance of government securities in financial institutions' portfolios, both private sector credit and the corporate bond market are small relative to EMs, though less so relative to countries with similar per capital income.

- India's labor regulation, which is tighter than in most OECD countries, should move toward protecting workers rather than jobs; improving workers' skills is another priority (*More and Better Jobs in South Asia*, World Bank, 2011).



- Improved agricultural productivity, a focus of the 12<sup>th</sup> Plan, would reduce structural pressures on food prices. FDI in the multibrand retail sector could also help by making supply chains more efficient.
- Trade liberalization, an educated work force, access to information flows and technology are all associated with increased sophistication of exports and productivity (see Box 3).

**24. Many of these reforms would pay dividends on inclusiveness.** Improved infrastructure would enhance the rural poor's access to markets. The 12<sup>th</sup> Plan Approach Paper has identified better irrigation and seeds and removal of controls that inhibit a unified market for agricultural products as priorities to raise agricultural productivity, which would

raise rural incomes. Enhanced education would improve job prospects for India's rapidly growing working age population, while more liberal labor regulation would facilitate job creation in the formal sector.

### Authorities' Views

**25. The authorities believe structural issues are not an important cause of the current investment slowdown.** They note that other factors, such as monetary tightening, the slowing global economy, and the depreciation of the rupee have damaged sentiment. Progress on policies has been measured, but the government indicates that it is no slower than during 2004-2007, when the economy grew more rapidly.

**26. The authorities cite numerous areas where progress on structural reform has been made.** Interest rate liberalization has been completed, FDI regulation has been eased, amendments to the law governing the Life Insurance Corporation of India to boost its capital have been approved, the National Manufacturing Strategy has been proposed with the aim to increase the share of manufacturing, and the Land Acquisition and Mining Laws, which should facilitate infrastructure building, have been submitted to Parliament. On the crucial energy sector, lending to state electricity boards has been conditioned on raising tariffs (which some states have done) and reducing transmission and distribution losses.

**27. The government will push forward with further measures in 2012/13.** The 2012/13 Budget is expected to reduce investment roadblocks, particularly in areas such as infrastructure and agriculture. Negotiations related to the GST are ongoing, and recent progress bodes well. The

## Financial Stability and Reform

**28. The FSAP concluded that the financial system is broadly stable but some areas could be strengthened (see accompanying FSSA).** India's financial system has developed rapidly in recent years and capital ratios as well as return on assets are adequate. However, non performing assets (NPAs) rose 30 percent in the year to September 2011 to 2.8 percent of total advances (partly reflecting problems in priority lending, infrastructure, and accounts restructured during the GFC), provision coverage remains low, and hybrid structures account for a relatively high proportion of capital. The authorities have moved to tie public bank recapitalization to improved performance, and increased inter-regulatory information sharing. However, an important risk is that concentration limits are considerably less stringent than international good practice. Increased oversight of corporate risks (including FX open positions) and stronger consolidated supervision by lead regulators are warranted. Granting greater powers to supervisors would also help resolve nonviable financial entities.

authorities plan to address other areas, such as the need to reduce skills mismatches and improve agricultural productivity, in the 12<sup>th</sup> Plan. Finally, the authorities noted that broadening the benefits of economic reform will be a priority under the 12<sup>th</sup> Plan.

**29. Enhancing infrastructure financing is a key area of focus for financial sector development.**<sup>4</sup> Public banks' lending cannot keep pace with rising needs without raising sectoral and group exposures and asset-liability mismatches to imprudent levels, which underscores the need to diversify funding sources beyond banks. In recent years, the authorities have taken steps to channel more savings into infrastructure. They have raised limits on foreign investment (FII) in bonds and enabled infrastructure finance companies to buy seasoned infrastructure loans and borrow abroad. Uptake on many of these measures has been low, however, reflecting nonfinancial and scheme design issues, and insufficient bond market liquidity.

**30. Continued reforms to fixed-income markets, especially the development of the corporate bond market, would facilitate**

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<sup>4</sup> The FSAP team looked at a broad range of developmental issues, focusing on development of financial markets, especially related to corporate bonds and insolvency proceedings; financing infrastructure; and broadening consumer protection and financial inclusion.

**funding for infrastructure and large projects.** Lowering mandatory bank holdings of public debt (the statutory liquidity ratio, SLR), encouraging banks to trade bonds (e.g. by increasing the share of bonds that must be marked to market) and relaxing restrictions on repo collateral and CDS while continuing to raise FII debt limits would increase liquidity and facilitate the development of a yield curve for pricing corporate bonds. Easing investment guidelines for domestic institutional investors, and relaxing restrictions on credit enhancements would increase demand for corporate bonds. Approving the Pension Fund Regulatory and Development Agency (PFRDA) bill would give impetus to the pension fund industry and promote long-term investments. Improving the insolvency regime, increasing investor protection, and continuing to develop instruments to hedge interest rate risk would also help.

**31. Broadening the reach of the financial system can support inclusive growth.** Easing regulations that raise the cost for banks to operate in underserved areas and allowing a greater role for business correspondents is needed to extend banking services to the unbanked. Greater SME financing requires larger corporates shifting to capital markets and more effective contract enforceability.

#### **Authorities' Views**

**32. The authorities view the FSAP as a useful and collaborative exercise that**

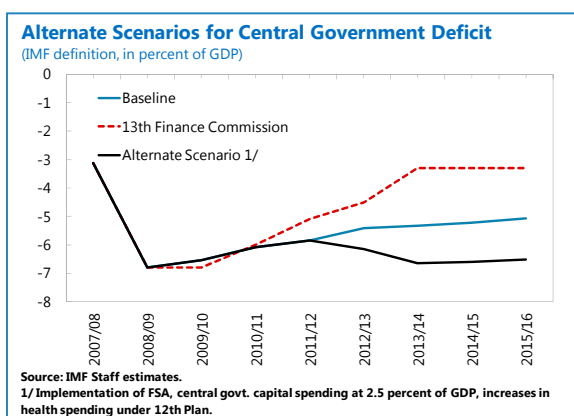
**complements their 2008 Financial Self-Assessment.** The broad assessment of financial sector's stability and deepening since 2001 agreed with that of the Self-Assessment. The authorities concur that in areas such as bank resolution, enhancement of lateral bank supervision and information-sharing, there is room for improvement, and measures are already being taken. On the other hand, the RBI believes that concentration risks can be adequately addressed through sectoral and group limits that are already in place, and that the recent rise in NPAs is transitory and compares favorably with peer emerging market economies.

**33. The authorities are also confident about their strategy for financial development.** The authorities note that five companies have requested licenses to open infrastructure debt funds and that issuance of tax-free infrastructure bonds has been facilitated. The authorities also agree that enhancing borrowing opportunities for SMEs will require further development of the corporate bond market, noting that reducing lock-in periods and allowing the transfer of bond holding ceilings along with bond sales should improve liquidity. Several measures such as monitoring unhedged foreign currency exposure and limits to underlying exposure of corporate to derivatives have been taken to limit corporate risk exposure. Finally, financial inclusion remains a strong priority and measures to extend the reach of financial services are being undertaken through

regulatory incentives and use of technology with a view toward profitability, thus ensuring

## Fiscal Reform

**34. Fiscal consolidation and reforms are essential complements to structural reforms.** The FC roadmap would reduce the public sector's absorption of resources, thus



stimulating private investment. GST reform is expected to create a unified market across India, while reorienting spending to infrastructure and social sectors is critical to ease supply constraints, make growth more inclusive, and reduce skill mismatches.

**35. Reducing the deficit would allow relaxation of financial restrictions currently employed to ensure the government's access to sufficiently low-cost finance.**<sup>5</sup> The SLR requires banks to hold 24 percent of deposits in government or other approved securities, and pension and insurance funds are also subject to tight investment guidelines. This large flow of long-term, low-risk assets

<sup>5</sup> See also G-20 India Sustainability Report 2011, prepared by Staff of the IMF.

banks will stay in these markets for the long run.

has discouraged private sector long-term lending and, when combined with capital controls, has allowed India to finance persistent budget deficits at stable and relatively low costs. The authorities have gradually eased financial restrictions—savings deposit rates have been freed, capital controls eased, and the SLR reduced. Nevertheless, a lower deficit would allow these restrictions to be loosened further, supporting development of the corporate and public bond markets, allowing the financial system to allocate capital to more productive areas, lowering the cost of finance for private borrowers, and supporting growth.

**36. The medium-term FC target is broadly consistent with a budget deficit “Golden Rule”.** To reach 9 percent growth, the 12<sup>th</sup> Plan Approach Paper calls for public investment of 9-10 percent of GDP, half of which would need to be spent by the central and state governments. The FC target of a 5 percent of GDP deficit for the general government would thus entail government borrowing almost exclusively for investment purposes. Over five years, freeing diesel prices and reforming other subsidies could close about two-thirds of the gap with the baseline scenario, while bringing indirect taxes back to pre-crisis levels would close the rest.

**37. The approval of long-delayed tax reforms would have positive growth effects.**

Both the GST and the new Direct Tax Code (DTC) are still being negotiated. However, the central government's broadening of the base of indirect taxation to approximate the eventual GST base and the recent important agreement on the services list for the GST show that progress is being made. The FC estimated that the GST would boost efficiency by 1½ percent of GDP.

**38. Expenditure reforms, which the government has repeatedly committed to, are vital to ensure medium-term fiscal consolidation.**

The government is aiming to boost spending on public investment, health, and food subsidies, while containing non-priority expenditure. Subsidies have been an important exception to an otherwise relatively successful containment of non-priority spending, while slowing growth and rising expectations for social spending will make maintaining budget discipline even more difficult. Liberalization of fuel prices, especially diesel, and rationalization of fertilizer and gas subsidies will be crucial to bringing the deficit down, though support for the most vulnerable must be ensured. Institutional reforms such as tighter escape clauses from the Fiscal Responsibility Act and an independent review mechanism for fiscal policy, as proposed by the FC, would help implementation. Recapitalization of public banks, which constitute about ¾ of the overall system, guarantees of public insurance policies, and India's growing PPP program, will require more consistent forecasting of potential government

outlays (Box 6). Finally, the poor financial position of several state electricity boards should be resolved with tariff changes and improvements in efficiency.

**39. Improving spending efficiency will be particularly important.**

India's Unique Identification program (UID), already the world's largest biometric database, is expected to cover one-third of the country's population – 400 million people – by end-2012. Pilot projects using the UID to target social benefits have begun and could represent an important step in broadening the reach of government programs at lower cost.

**Authorities' Views**

**40. Fiscal consolidation is well underway and medium-term targets will be met.**

The debt-to-GDP ratio is in within easy reach of the FC target of 68 percent of GDP by 2014-15. The authorities note that the deficit consolidation path is frontloaded, and that there will be space in the remainder of the FC period to reach the medium-term target of a 3 percent of GDP budget deficit for the central government.

**41. The authorities note various structural measures to improve the implementation of fiscal policy.**

The 12<sup>th</sup> Plan will make improvement of expenditure efficiency a priority and the UID will pave the way for direct cash transfers. Bringing down fuel and fertilizer subsidies is important, but will have to be done cautiously to minimize dislocations

## BOX 6. ACCOUNTING FOR CONTINGENT LIABILITIES FROM PPPs<sup>1</sup>

- India's increasing use of PPPs for infrastructure creates new liabilities.** Private finance for infrastructure was US\$51 billion in 2010/11, or around 2.8 percent of GDP, but the 12<sup>th</sup> Plan is expected to call for it to rise to 5 percent of GDP. India's PPP program, at US\$129 billion already one of the world's largest, could thus grow rapidly. However, PPPs create contingent liabilities, such as annuities or termination payments or the need to finish a desired program after an investor goes bankrupt.
- These risks should be presented transparently.** Some countries, such as the United States, require contingent liabilities such as public guarantees to be incorporated into the budget; the United Kingdom also does this with PPPs. Chile annually presents all contingent public liabilities, including PPPs, calculating both a maximum cost to the government if all guarantees are called (in 2010, around 4 percent of GDP) as well as a probability-based estimate of expected outflow (only around 1/10,000 of GDP).



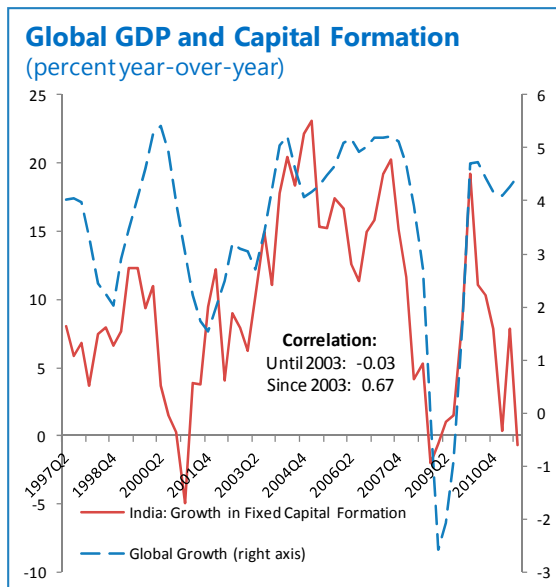
- Estimates for India's PPP portfolio can also be produced, though data are sparse.** We make simplifying assumptions of project duration and the time remaining on each contract, and also assume construction liabilities are capped at project cost, while operating income is related to construction cost and prorated for contracts that can last up to 30 years. Assuming default probabilities approximately comparable to S&P ratings of BB (for construction) and BBB- (for operation), we find relatively small exposures. Maximum exposure drops drastically from a peak of around 0.3 percent of GDP as projects currently under construction come online and reduce potential losses (Figure 1). As for the risk weighted measure, with 95 percent probability losses remain under Rs 20 billion, or 0.02 percent of GDP. However, different assumptions could produce different results. More accurate calculations, based on the deeper database of information available to the authorities, would be worthwhile, especially as these programs expand.

<sup>1</sup> Prepared by James P. Walsh (APD).



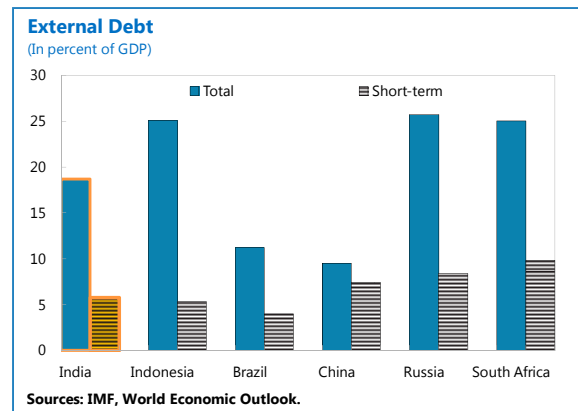
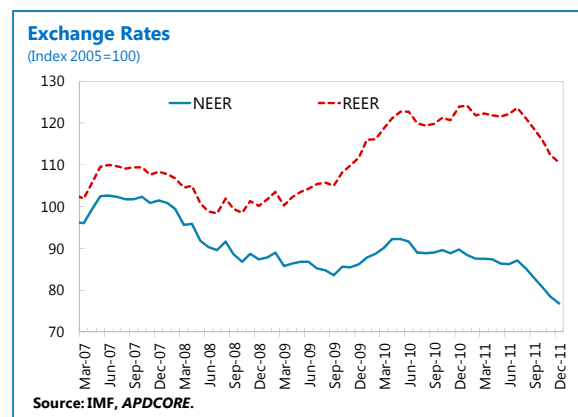
### C. Risks: How Much of a Threat to India are the Advanced Economies' Troubles?

**42. Risk analysis suggests that India is vulnerable to a prolonged malaise in advanced economies.** Though India is less open than most Asian EMs, the confidence and financial effects of a protracted downturn in advanced economies could have a sizable impact on India's growth (Annex 1). As shown during the GFC, while India's consumption is fairly insulated from global factors and imports typically compress sharply when a crisis hits, India's investment has become highly correlated with the global cycle. This suggests that the financial and confidence channels tend to dominate the trade channel in the transmission of external shocks.



**43. Euro zone banks account for about a third of BIS banks' claims on India and their deleveraging could have a material impact, particularly if global banks are severely affected.** Euro zone banks' claims

on India amount to 3.2 percent of India's GDP; UK banks have 4.2 percent and US banks 3.6 percent. Given foreign banks' small retail presence in India, BIS-reporting banks' claims on India are mostly cross-border and short term, exacerbating vulnerabilities. Also, European banks are important providers of trade credit and major players in FX derivatives markets. Global banks so far are



reducing their claims slowly and are being replaced by other banks, especially from the region, though compensating for a sharp and abrupt deleveraging might not be easy. Domestic banks, especially public banks which



would likely benefit from deposit flight, could also help replace foreign financing.

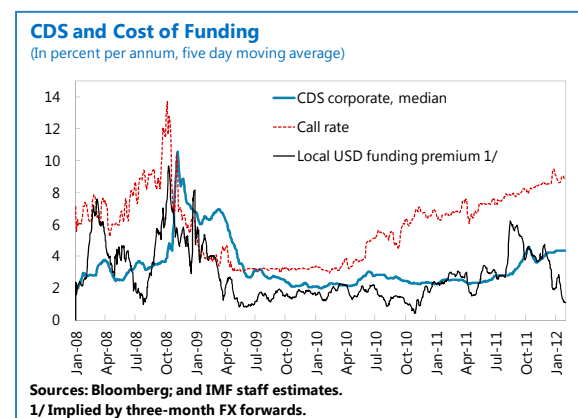
**44. External stability risks are currently manageable but could intensify appreciably in a severe global crisis.** The current account deficit is expected to remain close to its estimated norm of 3 percent of GDP (Figure 4). Exports have continued to gain market share, and capital goods account for the majority of non-oil imports. The real effective exchange rate (REER) had appreciated by 10 percent in 2010 because of inflation differentials, but with the nominal depreciation in 2011, the REER is estimated to be broadly in line with fundamentals. Reserve coverage is adequate (1.8 times the 2011 gross external financing requirement) and external debt, which has remained at about 20 percent of GDP, compares well to other major EMs. But as seen in the second half of 2011, spikes in global risk aversion lead to a larger rupee depreciation than for other regional currencies, because India's current account deficit is increasingly financed by external commercial borrowing and portfolio investment and hence is more vulnerable to sudden stops of capital inflows.

**45. Corporates constitute an important channel of contagion.** They have higher leverage than their EM peers and are freer to take FX positions as capital controls on them are less stringent than on financial institutions and individuals. During the GFC, as U.S. dollar liquidity dried up, many Indian multinationals

resorted to onshore borrowing, adding to domestic strains and leading to a spike in money market rates. Also, many suffered losses as a result of exchange rate depreciation. As India combines low household incomes with large and sophisticated firms, bank balance sheets are dominated by corporate lending, resulting in high concentration risks, a concern noted in the FSAP. A significant deterioration in asset quality could result from a crisis, and public banks, which have lower levels of capital and provisioning, could be particularly affected.

**46. If downside risks materialize, monetary policy can move first, followed by carefully designed fiscal measures.**

Monetary policy can provide immediate relief through liquidity provision, which the RBI has already started doing in recent months, and interest rate cuts, especially if the global shock is accompanied by lower oil prices, which will reduce inflationary pressures. Fiscal measures could also help, but should be



taken cautiously as expansionary measures are difficult to reverse, as shown after the

GFC. Available fiscal space will depend on how much progress is made on fiscal consolidation before a crisis hits. At current levels of the fiscal deficit and debt, the fiscal room would be small.

**47. The flexibility of the exchange rate remains a useful buffer against external shocks.** Since the GFC and until August 2011, RBI intervention was minimal, and recent interventions have fallen within the RBI's stated policy of intervening only to address severe market dislocations and foreign exchange liquidity shortages. Recent measures by the RBI to restrict banks' net foreign exchange (FX) open positions and corporates' ability to trade in the onshore forward market seem to have contributed to stabilizing the rupee. The authorities have continued to gradually liberalize capital flows, such as by freeing interest rates on nonresident accounts, facilitating the refinancing of external debt, and allowing foreign individuals to invest in equities directly. Consideration could also be given to increasing the all-in cost spreads on external commercial borrowing to further ease external financing constraints.

### **Authorities' Views**

**48. The authorities agree that difficulties in advanced economies pose serious risks, but underscore India's resilience.** Both trade and financial channels could be important in a crisis, though recent trade diversification should mitigate the

impact and the main sources of India's growth are domestic. The authorities feel the managed capital account and Indian banks' minimal exposure to Euro zone assets would limit financial spillovers. While the recent depreciation has been comparable to that experienced during the GFC, high oil prices have offset the impact on the current account.

**49. While noting that fiscal space is more constrained than in 2008, the authorities emphasize that a crisis response will need to be a coordinated event.** Actions by both the RBI and the government would be warranted. They also cite reserves as a line of defense while standing by the floating exchange rate regime. The RBI believes FX intervention will remain justified to smooth volatility or to address severe FX liquidity shortages.

## STAFF APPRAISAL

**50. India's growth has slowed due to cyclical and structural factors.** Supply constraints, rising funding costs, and the external environment have pulled growth down below trend in 2011/12, though not yet sufficiently for sustained disinflation. While still high relative to other EMs, bringing Indian growth back to potential and ensuring its inclusiveness will require continued vigilance on cyclical policies and a reinvigoration of the structural agenda.

**51. Growth risks are on the downside.** The main domestic risks stem from the pace of structural reform implementation and government decision making, and continued high inflation, while the highly uncertain global outlook also weighs on investment and exports.

**52. Given decelerating but still high inflation, keeping policy rates unchanged until inflation is clearly on a downward trend is warranted.** Since most of the recent decline in inflation is due to base effects, cutting rates immediately would be premature. Looking beyond March when base effects end, the RBI should stand ready to raise rates if sequential inflation rises again, while it could afford to cut rates if the inflation momentum clearly eases. Over the medium term, the RBI is rightly aiming at lowering inflation further to below 5 percent.

**53. Fiscal policy should stay the course of medium-term consolidation, resisting pressures to introduce a demand stimulus.** The FC's medium-term roadmap remains appropriate. The 2011/12 budget slippage may entail a more gradual return to the path, but reconstituting fiscal space is a worthwhile goal in light of heightened external risks. Fiscal consolidation would have positive spillover effects on private sector growth by reducing the public sector's absorption of resources and allowing the existing financial restrictions to be removed gradually. Fiscal reforms are preferable to demand stimulus for reviving investment. In particular, reorienting expenditure toward capital and social spending as envisaged by the authorities is welcome as it can boost investment and promote inclusive growth. Decontrolling diesel prices, rationalizing other fuel and fertilizer subsidies, and moving toward direct cash transfer under UID are essential to keep deficits under control and free space for more growth-enhancing spending. Approval of the GST should also be a priority.

**54. The revival of growth should come from structural reforms, rather than from monetary and fiscal stimulus.** Structural impediments, some of which have intensified in recent years, are important contributors to India's investment slowdown. Removing obstacles to investment is crucial, especially in

energy, where a broad range of factors are at play. Beyond this, passing legislation to facilitate land acquisition and mining would promote infrastructure provision and ensure that India's high growth potential remains intact. Financial reforms are needed to increase corporate and household access to credit and diversify funding sources. On the other hand, given the large fiscal deficit and elevated inflation, fiscal and monetary policy cannot be relied upon to stimulate investment and growth.

**55. Such reforms would also make growth more inclusive.** Addressing skill mismatches, moving toward a more liberalized labor market, and improving agricultural productivity will support income growth and formal job creation, especially for the less privileged in society.

**56. While India's financial system is broadly stable, there is room to guard against future instability and further develop markets.** Measures to increase and improve the quality of bank capital are welcome, along with improving interregulatory cooperation and clarifying supervisory responsibilities. On the developmental front, continuing to develop fixed income markets will be essential to achieve infrastructure goals, which in turn will require reducing financial restrictions over time as fiscal consolidation progresses. Given concerns about the global environment, improvements to the resolution regime, increasing oversight of corporate risks,

and addressing group concentration risks in the banking sector are important.

**57. A slowdown in global growth, particularly if triggered by a sudden stop in capital flows, would have a serious impact on India.** Investment is increasingly tied to global cycles, corporates are relatively highly leveraged, and the external position, while quite manageable, is less favorable than during 2008. The resulting growth downturn could also lead to a substantial deterioration in asset quality in the financial system.

**58. In the event of a crisis, the flexible rupee would be an important buffer, while the scope for fiscal and monetary stimulus is more limited than in 2008.** The RBI's foreign exchange market policies appropriately limit intervention to extreme situations. The authorities' moves toward further gradual external liberalization are also welcome. In the event of a crisis, high debt and deficits point to the need to ensure a prospective fiscal expansion would be limited and focused on high-multiplier items such as indirect taxes and backlogged capital projects. Monetary policy could be eased, though the extent of easing will depend on trends in domestic inflation.

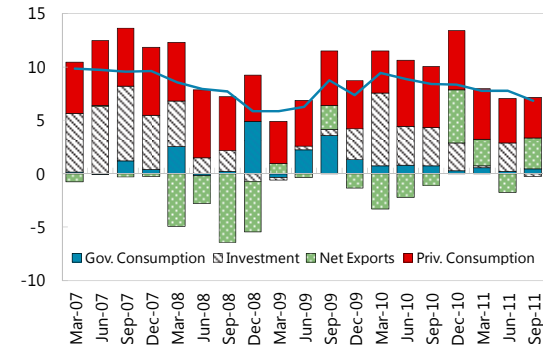
**59. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.**

### Figure 1. India: Conjunctural Developments

Growth is moderating, but inflation is still elevated.

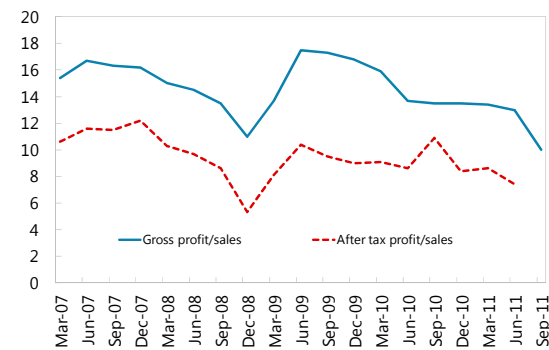
GDP growth has moderated because of weak investment.

**Contributions to Real GDP Growth**  
(In percent)



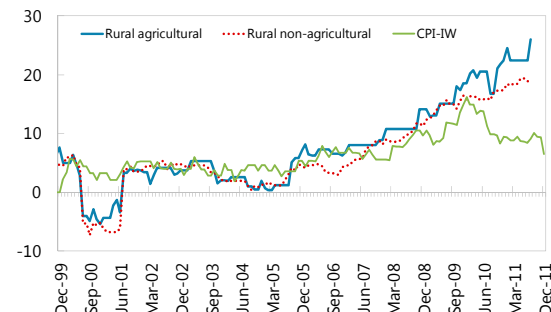
Corporate performance has reflected the moderation in the economy...

**Corporate Performance**  
(In percent)



Wage increases have outpaced inflation.

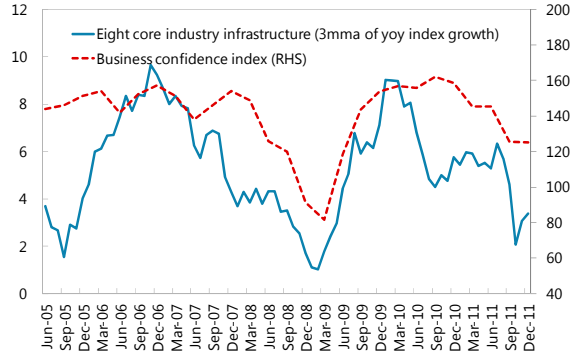
**Average Daily Wage 1/**  
(In percent, year over year growth)



1/ wage data are not widely available and only cover small segments of the labor market. The data presented here are from the Ministry of Labor.

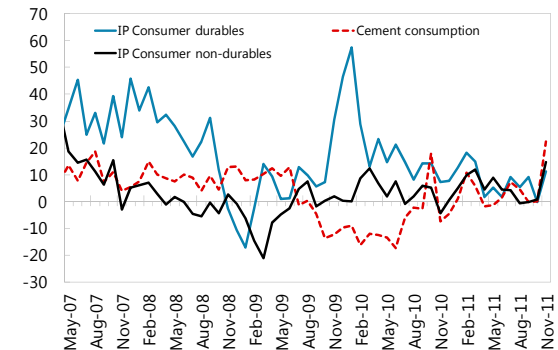
High frequency indicators have rebounded in recent months but still point to sluggish investment.

**Business Confidence and Core Industries**



...as have consumer goods and cement production, though they have started to recover.

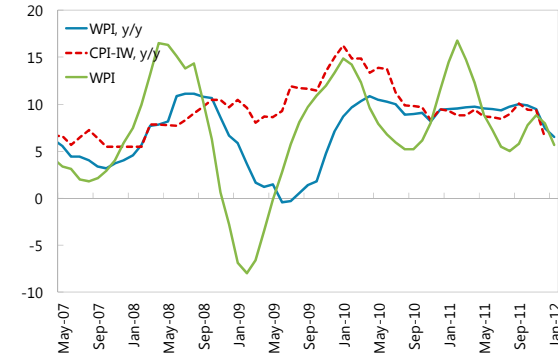
(y/y percent change)



Despite the recent moderation, inflationary pressures remain elevated.

**Inflation**

(In percent, annualized quarterly growth of 3mma sa)



Sources: Haver Analytics; CEIC Data Company Ltd., and India Premium Database; Bloomberg L.P.; and IMF staff calculations.

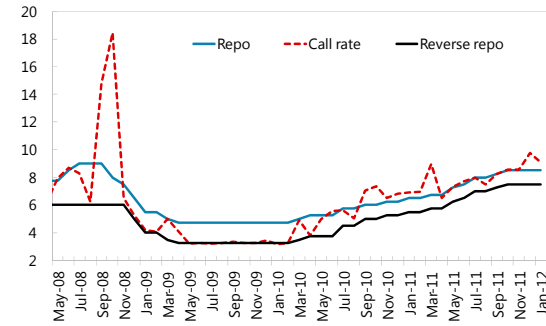
**Figure 2. India: Monetary and Financing Conditions**

Real interest rates have risen gradually, and credit and corporate issuance have slowed.

*The call money rate has increased more than policy rates...*

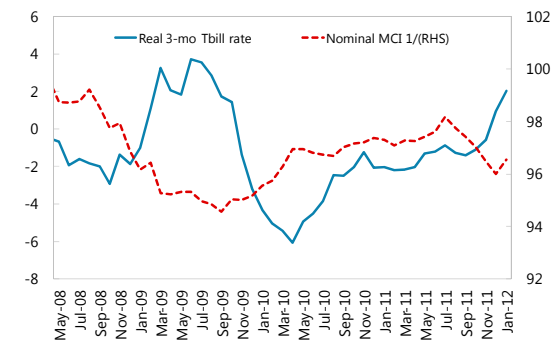
**Interest Rates**

(In percent)



*...but monetary accommodation has been removed gradually and was affected by the rupee depreciation in H2 2011.*

**Monetary Conditions**

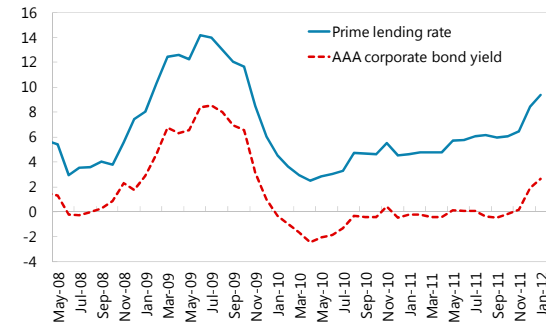


1/ 2007=100. An increase represents a tightening of monetary policy.

*The real cost of borrowing has risen...*

**Real Rates**

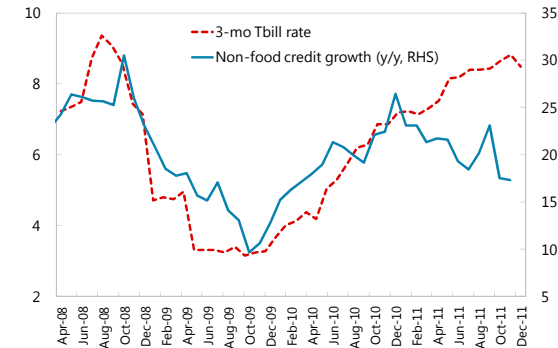
(In percent, deflated by WPI)



*...and credit growth has moderated.*

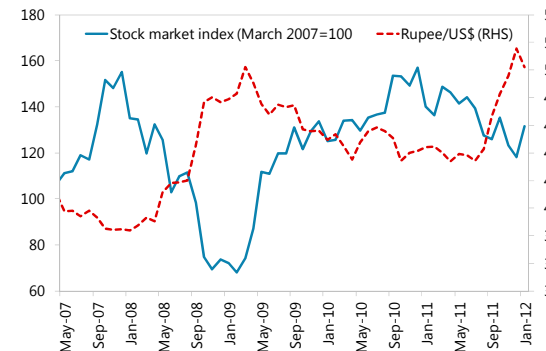
**Credit Growth**

(In percent)



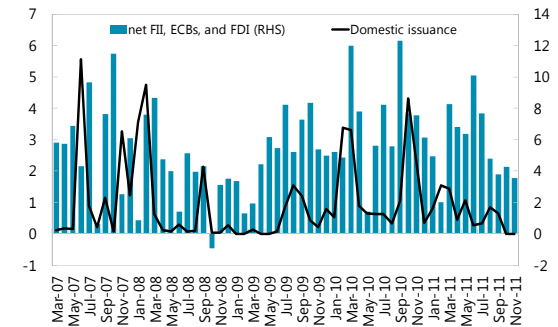
*With the stock market slumping since July 2011 in tandem with the depreciation of the rupee...*

**Stock Market and Exchange Rate**



*...domestic issuance and capital inflows have declined.*

(In billions of U.S. dollars)



Sources: Reserve Bank of India; Bloomberg L.P.; CEIC Database; and IMF staff estimates.

1/ The MCI is based on the average of repo and reverse repo rate and the NEER.

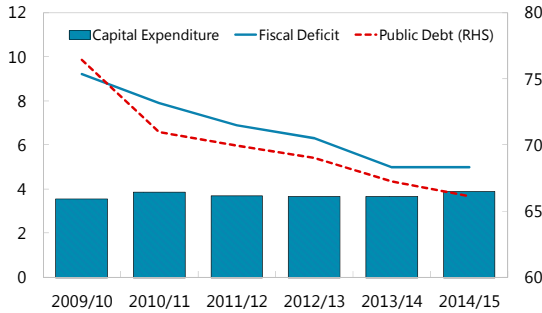
**Figure 3. India Fiscal Indicators**

With this year's target out of reach, returning to consolidation will be a challenge.

Rapid nominal GDP growth has brought debt down, and the government remains committed to its original consolidation plan.

However, consolidation is significantly slower than in 2003-2007.

**13th Finance Commission Consolidation Path 1/**

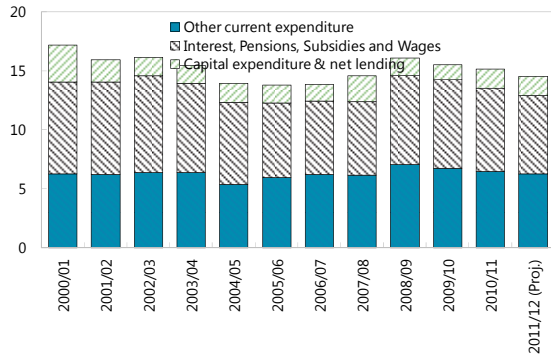


1/ Paths are for general government.

Spending in areas targeted for cuts, particularly subsidies, has remained high, slowing the reorientation of spending.

**Composition of Expenditure**

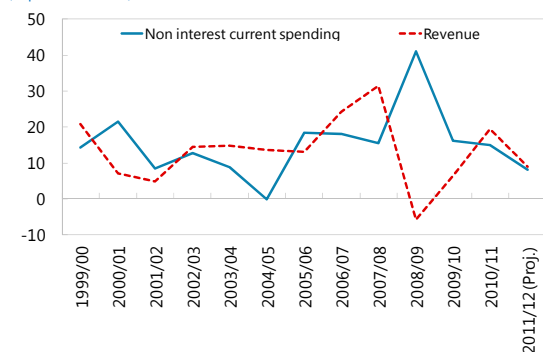
(In percent of GDP)



Controlling current expenditure will be key to reaching consolidation targets...

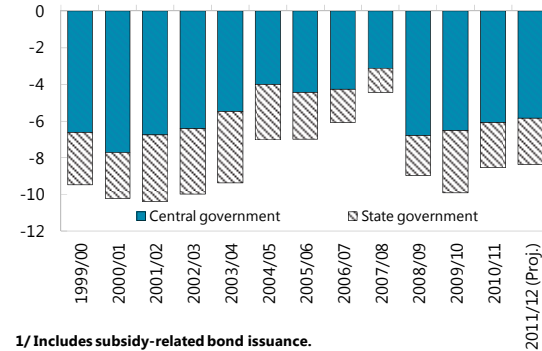
**Nominal Growth**

(In percent of GDP)



**Government Balance**

(In percent of GDP) 1/

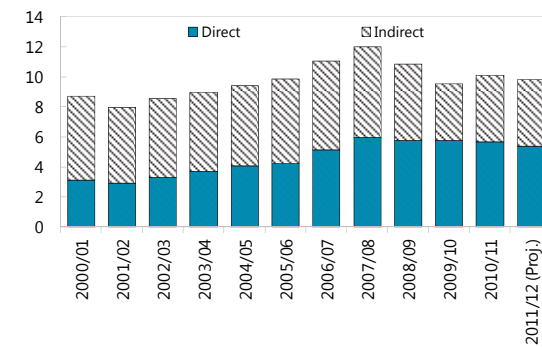


1/ Includes subsidy-related bond issuance.

Despite base broadening, revenue buoyancy has been low.

**Central Government Revenue**

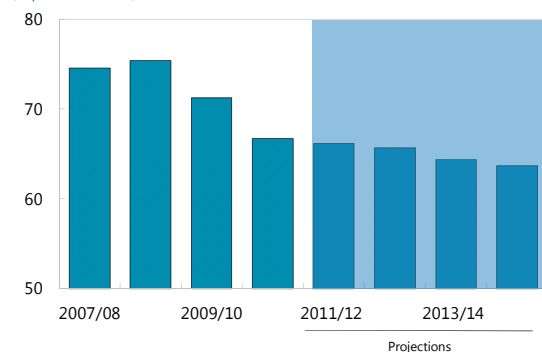
(In percent of GDP)



... but under current trends the debt burden will fall only marginally in the medium term.

**Public Debt**

(In percent of GDP)



Sources: Country authorities; CEIC Database; and IMF staff calculations.



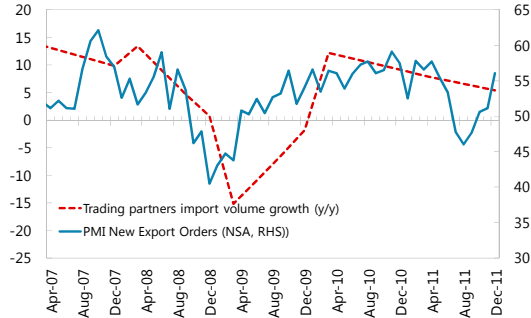
**Figure 4. India: External Vulnerability**

External vulnerabilities have increased but remain manageable.

External demand has slowed...

**Import Demand**

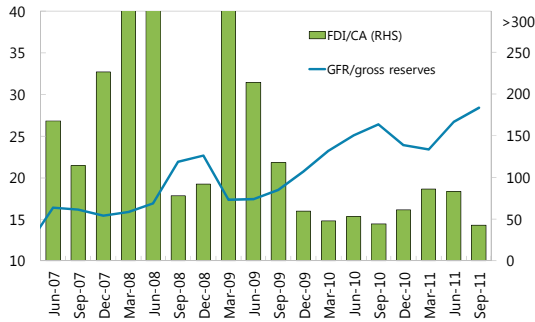
(PMI, above 50 = expansion)



The gross financing requirement has risen and the composition of the current account deficit financing has worsened.

**Gross Financing Requirement**

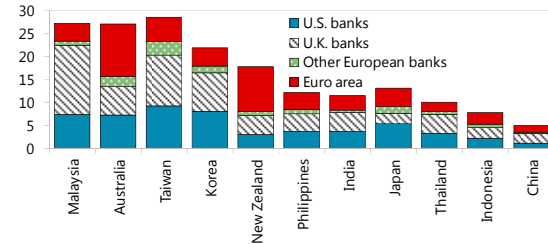
(In percent)



BIS banks' claims on India are significant.

**Consolidated Foreign Claims of European and U.S. Banks on Selected Asian Economies 1/**

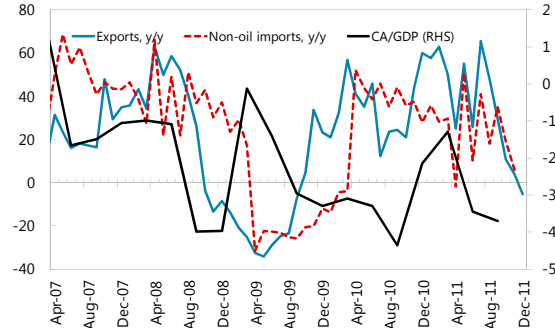
(In percent of GDP; as of 2011 Q3)



Sources: Bank for International Settlements (BIS); CEIC Data Company Ltd.; Haver Analytics; and IMF staff calculations.  
1/ Claims are on immediate borrower basis. Uses sum of quarterly GDP in U.S. dollar between 2010:Q4 and 2011:Q3 in the denominator.

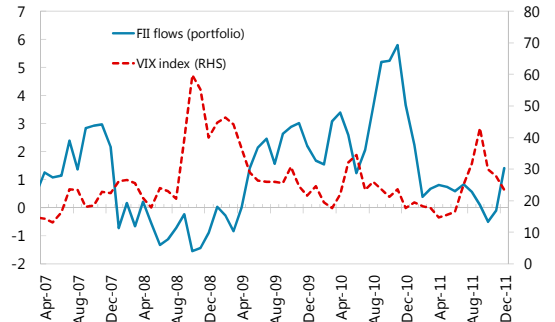
...as have export and non-oil import growth, but the current account deficit has remained manageable.

(In percent)



Portfolio inflows have declined with the spike in global risk aversion.

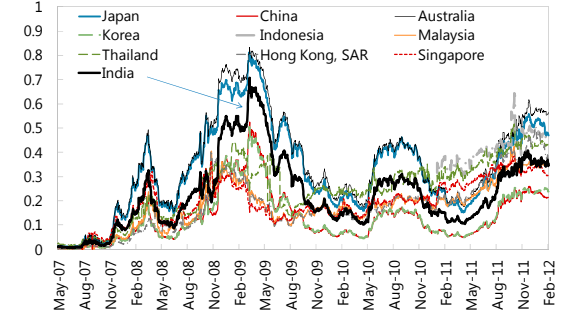
(3mma; in billions of US\$)



Indian banks are particularly vulnerable to the failure of a major UK bank.

**Regional Financial Institutions**

(Conditional probability of at least one bank in the economy would fail if a major UK bank was in distress)



Sources: Bloomberg, Markit, and author's estimates.

Sources: CEIC Database; Haver Analytics; Markit; and IMF staff estimates.



**Table 1. India: Millennium Development Goals, 1990–2010 1/**

	1990	2004	2006	2008	2009	2010
<b>Eradicate extreme poverty and hunger 2/</b>						
Income share held by lowest 20%	...	...	...	...	...	...
Malnutrition prevalence, weight for age (% of children under 5)	...	...	43.5	...	...	...
Poverty gap at \$1 a day (PPP) (%)	...	...	...	...	...	...
Poverty headcount ratio at \$1 a day (PPP) (% of population)	...	...	...	...	...	...
Poverty headcount ratio at national poverty line (% of population)	...	27.5	...	...	...	...
Prevalence of undernourishment (% of population)	...	...	...	19.0	...	...
<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)	...	...	68.5	...	...	...
Primary completion rate, total (% of relevant age group)	...	84.2	86.7	95.7	...	...
School enrollment, primary (% net)	...	89.8	89.4	92.1	...	...
<b>Promote gender equality 4/</b>						
Proportion of seats held by women in national parliament (%)	5.0	9.0	8.3	9.1	10.7	10.8
Ratio of girls to boys in primary and secondary education (%)	n.a.	90.0	90.2	...	...	...
Ratio of young literate females to males (% ages 15-24)	67.1	...	...	...	...	...
Share of women employed in the nonagricultural sector (% of total nonagricultural employm	12.7	17.9	18.1	...	...	...
<b>Reduce child mortality 5/</b>						
Immunization, measles (% of children ages 12-23 months)	56.0	61.0	64.0	74.0	74.0	74.0
Mortality rate, infant (per 1,000 live births)	83.8	...	57.2	50.8	49.5	48.2
Mortality rate, under-5 (per 1,000)	118.2	...	76.5	66.8	64.7	62.7
<b>Improved maternal health 6/</b>						
Births attended by skilled health staff (% of total)	...	...	46.6	52.7	...	...
Maternal mortality ratio (modeled estimate, per 100,000 live births)	570.0	...	...	230.0	...	...
<b>Combat HIV/AIDS, malaria, and other diseases 7/</b>						
Contraceptive prevalence (% of women ages 15-49)	43.0	...	56.3	54.0	...	...
Incidence of tuberculosis (per 100,000 people)	168.0	...	205.0	196.0	190.0	185.0
Prevalence of HIV, female (% ages 15-24)	...	...	...	...	0.1	...
Prevalence of HIV, total (% of population ages 15-49)	...	...	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	...	...
Forest area (% of land area)	21.5	...	22.8	...	...	23.0
GDP per unit of energy use (constant 2000 PPP \$ per kg of oil equivalent)	3.3	4.4	4.7	5.1	5.1	...
Improved sanitation facilities (% of population with access)	18.0	...	...	31.0	...	...
Improved water source (% of population with access)	72.0	...	...	88.0	...	...
Nationally protected areas (% of total land area)	...	...	...	...	...	...
<b>Develop a global partnership for development 9/</b>						
Fixed line and mobile phone subscribers (per 1,000 people)	0.6	9.1	18.6	33.8	48.7	67.2
Internet users (per 1,000 people)	...	2.0	2.9	4.6	5.4	7.8
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	...	...	...	...
Unemployment, youth male (% of male labor force ages 15-24)	...	10.4	...	...	...	...
Unemployment, youth total (% of total labor force ages 15-24)	...	10.5	...	...	...	...
<b>General indicators</b>						
Fertility rate, total (births per woman)	4.0	3.0	2.8	2.7	2.7	...
GNI per capita, Atlas method (current US\$)	390.0	640.0	850.0	1,080.0	1,220.0	1,330.0
GNI, Atlas method (current US\$) (billions)	330.9	687.2	942.1	1,236.7	1,404.8	1,553.9
Gross capital formation (% of GDP)	24.2	32.8	35.7	34.5	36.5	34.8
Life expectancy at birth, total (years)	58.2	61.9	63.7	64.4	64.8	...
Literacy rate, adult total (% of people ages 15 and above)	48.2	...	62.8	...	...	...
Population, total (millions)	849.5	1,079.7	1,109.8	1,140.0	1,155.3	1,170.9
Trade (% of GDP)	15.7	36.9	45.3	52.7	44.9	46.3

Source: World Bank, *World Development Indicators*, 2011.

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

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

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

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

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

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

7/ Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to

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

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, 2007/08–2012/13 1/

I. Social Indicators						
<b>GDP (2010/11)</b>		<b>Poverty (Percent of population)</b>				
Nominal GDP (billions of U.S. dollars):	1,684	Headcount ratio (2005):		37.2		
GDP per capita (U.S. dollars):	1,420	Undernourished (2000):		19.0		
<b>Population characteristics (2010)</b>		<b>Income distribution (2005, WDI)</b>				
Total (in billions):	1.2	Richest 10 percent of households:		31.1		
Urban population (percent of total):	31	Poorest 20 percent of households:		8.1		
Life expectancy at birth (years):	65	Gini index:		36.8		
II. Economic Indicators						
	2007/08	2008/09	2009/10	2010/11 Prel.	2011/12 Est.	2012/13 2/ Proj.
Growth (y/y percent change)						
Real GDP (at factor cost)	9.3	6.7	8.4	8.4	6.8	7.0
Real GDP (at factor cost, calendar year basis)	9.4	7.3	8.0	8.4	6.8	7.1
Industrial production	15.5	2.5	5.3	8.2	...	...
Prices (y/y percent change, average)						
Wholesale prices (2004/05 weights)	4.7	8.1	3.8	9.6	8.7	7.2
Wholesale prices (2004/05 weights, end of period)	7.7	1.6	10.4	9.7	6.8	7.0
Consumer prices - industrial workers (2001 weights)	6.2	9.1	12.4	10.4	8.1	8.5
Saving and investment (percent of GDP)						
Gross saving 2/	36.4	31.7	33.5	31.3	31.3	30.4
Gross investment 2/	37.7	34.0	36.3	34.0	34.0	33.4
Fiscal position (percent of GDP) 3/						
Central government deficit	-3.1	-6.8	-6.5	-6.1	-5.9	-5.8
General government deficit	-4.4	-9.0	-9.9	-8.8	-8.1	-7.7
General government debt 4/	74.6	75.4	71.3	66.7	66.2	65.7
Money and credit (y/y percent change, end-period) 5/						
Broad money	21.4	19.3	16.8	16.0	31.1	18.2
Credit to commercial sector	21.1	16.9	15.8	21.3	18.8	...
Financial indicators (percent, end-period) 6/						
91-day treasury bill yield	7.2	5.0	4.4	7.3	8.6	...
10-year government bond yield	7.6	7.0	7.8	8.0	8.4	...
Stock market (y/y percent change, end-period)	19.7	-37.9	80.5	10.9	...	...
External trade 7/						
Merchandise exports (US\$ billions)	166.2	189.0	182.4	250.5	274.2	307.4
y/y percent change	28.9	13.7	-3.5	37.3	9.5	12.1
Merchandise imports (US\$ billions)	257.6	308.5	300.6	381.1	428.2	489.1
y/y percent change	35.1	19.8	-2.6	26.7	12.4	14.2
Balance of payments (US\$ billions)						
Current account balance	-15.7	-27.9	-38.2	-45.9	-47.6	-56.3
(in percent of GDP)	-1.3	-2.3	-2.8	-2.7	-2.8	-3.0
Foreign direct investment, net	15.9	22.4	18.0	9.4	18.8	22.3
Portfolio investment, net (equity and debt)	27.4	-14.0	32.4	30.3	11.1	24.1
Overall balance	92.1	-20.6	13.0	12.9	5.5	17.1
External indicators						
Gross reserves (in billions of U.S. dollars, end-period)	309.7	252.0	279.1	293.1	298.6	315.7
(In months of imports) 8/ 9/	10.3	8.4	7.2	6.8	5.7	5.5
External debt (in billions of U.S. dollars, end-period) 8/	224.4	224.5	261.0	298.4	337.4	384.7
External debt (percent of GDP, end-period)	18.1	18.4	19.2	17.7	19.7	20.7
Of which: short-term debt 9/	6.8	6.7	6.7	6.9	8.0	8.7
Ratio of gross reserves to short-term debt (end-period) 9/	3.7	3.1	3.1	2.5	2.2	2.0
Debt service ratio 10/	5.3	5.1	4.9	4.7	5.6	5.8
Real effective exchange rate						
(y/y percent change, period average for annual data)	8.7	-6.8	8.0	11.6	...	...
Exchange rate (rupee/US\$, end-period) 6/	40.3	51.2	45.5	45.0	...	...

Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; Bloomberg L.P.; *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 2011/12, as of October 2011.

6/ For 2011/12, as of October 2011.

7/ On balance of payments basis.

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

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

10/ In percent of current account receipts excluding grants.

**Table 3. India: Balance of Payments, 2007/08–2012/13 1/**

(In billions of U.S. dollars)

	2007/08	2008/09	2009/10	2010/11 Prel.	2011/12 Est.	2012/13 Proj.
Current account balance	-15.7	-27.9	-38.2	-45.9	-47.6	-56.3
Merchandise trade balance	-91.5	-119.5	-118.2	-130.6	-153.9	-181.7
Merchandise exports	166.2	189.0	182.4	250.5	274.2	307.4
Merchandise imports	257.6	308.5	300.6	381.1	428.2	489.1
Oil	86.8	98.5	99.4	120.7	146.5	153.9
Non-oil	170.8	210.0	201.2	260.3	281.6	335.3
Non-factor services balance	38.9	53.9	36.0	48.8	58.8	78.7
Receipts	90.3	106.0	96.0	132.9	150.8	180.3
Of which: software services	40.3	46.3	49.7	55.5	...	...
Payments	51.5	52.0	60.0	84.1	92.0	101.6
Income, net	-5.1	-7.1	-8.0	-17.3	-11.3	-18.0
Transfers, net	41.9	44.8	52.0	53.1	58.8	64.7
Capital account balance	106.6	7.4	51.6	62.0	53.1	73.5
Direct investment, net	15.9	22.4	18.0	9.4	18.8	22.3
Of which: direct investment in India	34.7	41.7	33.1	25.9	37.7	42.7
Portfolio investment, net	27.4	-14.0	32.4	30.3	11.1	24.1
Government borrowing, net	2.1	2.4	2.9	4.9	-1.8	-2.4
Commercial borrowing, net	22.6	7.9	2.0	12.5	9.2	9.4
Short-term credit, net	15.9	-2.0	7.6	11.0	10.7	14.7
NRI deposits, net	0.2	4.3	2.9	3.2	5.1	5.6
Rupee debt	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Other capital, net 2/	22.5	-13.5	-14.0	-9.3	0.0	0.0
Errors and omissions	1.3	0.4	0.0	-3.0	0.0	0.0
Overall balance	92.2	-20.1	13.4	13.1	5.5	17.1
Valuation changes 3/	18.4	-37.7	13.6	1.0	0.0	0.0
Increase in gross reserve stock (including valuation changes)	-110.5	57.7	-27.1	-14.0	-5.5	-17.1
Memorandum items:						
Foreign exchange reserves	309.7	252.0	279.1	293.1	298.6	315.7
In months of next year's imports (goods and services)	10.3	8.4	7.2	6.8	5.7	5.5
Current account balance (percent of GDP)	-1.3	-2.3	-2.8	-2.7	-2.8	-3.0
Merchandise trade balance (percent of GDP)	-7.4	-9.8	-8.7	-7.8	-9.0	-9.8
Overall balance (percent of GDP)	7.4	-1.6	1.0	0.8	0.3	0.9
GDP in USD	1,238.5	1,223.2	1,361.0	1,684.4	1,711.9	1,855.9

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

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

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

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

Table 4. India: Macroeconomic Framework, 2007/08–2015/16 1/

	2007/08	2008/09	2009/10	Prel. 2010/11	Projections				
					2011/12	2012/13	2013/14	2014/15	2015/16
Growth (percent change)									
Real GDP (at factor cost)	9.3	6.7	8.4	8.4	6.8	7.0	7.4	7.6	7.8
Non-agricultural sector	10.1	8.1	9.3	8.5	7.4	7.7	8.1	8.3	8.5
Prices (percent change, period average)									
Wholesale prices (2004/05 =100)	4.7	8.1	3.8	9.6	8.7	7.2	6.4	5.4	5.4
Consumer prices	6.2	9.1	12.4	10.4	8.1	8.5	6.8	5.4	4.7
Saving and investment (percent of GDP)									
Gross saving 2/	36.4	31.7	33.5	31.3	31.3	30.4	30.9	30.9	31.0
Gross investment 3/	37.7	34.0	36.3	34.0	34.0	33.4	33.4	33.4	33.3
Fiscal position (percent of GDP)									
Central government balance 4/	-3.1	-6.8	-6.5	-6.1	-5.9	-5.8	-5.5	-5.4	-5.2
General government balance 4/	-4.4	-9.0	-9.9	-8.8	-8.1	-7.7	-7.6	-7.4	-7.2
General government debt 5/	74.6	75.4	71.3	66.7	66.2	65.7	64.5	63.7	63.0
External trade (percent change, BOP basis)									
Merchandise exports (in U.S. dollar terms)	28.9	13.7	-3.5	37.3	9.5	12.1	11.2	11.7	11.8
Merchandise imports (in U.S. dollar terms)	35.1	19.8	-2.6	26.7	12.4	14.2	9.2	12.5	12.3
Balance of payments (in billions of U.S. dollars)									
Current account balance	-15.7	-27.9	-38.2	-45.9	-47.6	-56.3	-51.8	-57.0	-58.5
(in percent of GDP)	-1.3	-2.3	-2.8	-2.7	-2.8	-3.0	-2.5	-2.5	-2.3
Foreign direct investment, net	15.9	22.4	18.0	9.4	18.8	22.3	19.9	21.9	24.2
Portfolio investment, net (equity and debt)	27.4	-14.0	32.4	30.3	11.1	24.1	22.6	24.9	27.5
Overall balance	92.2	-20.1	13.4	13.1	5.5	17.1	15.6	15.5	20.2
External indicators									
Gross reserves (in billions of U.S. dollars, end-period)	309.7	252.0	279.1	304.8	298.6	315.7	331.3	346.8	367.0
(in months of imports) 6/	10.3	8.4	7.2	6.8	5.7	5.5	5.2	4.8	4.8
External debt (in billions of U.S. dollars, end-period)	224.4	224.5	261.0	306.4	337.4	384.7	431.8	482.2	536.9
External debt (percent of GDP, end-period)	18.1	18.4	19.2	18.2	19.7	20.7	21.0	21.3	21.5
Of which : short-term debt 7/	6.8	6.7	6.7	6.9	8.0	8.7	9.1	9.7	10.1
Ratio of gross reserves to short-term debt (end-period) 7/	3.7	3.1	3.1	2.6	2.2	2.0	1.8	1.6	1.4
Debt service (percent of current account receipts)	5.3	5.1	4.9	4.7	5.6	5.8	6.0	6.0	6.0

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

1/ Data are for April-March fiscal years unless otherwise mentioned. Calendar year data in 2008/09 column indicate data for 2008, for instance.

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

3/ Statistical discrepancy adjusted.

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

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

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

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 5. India: Central Government Operations, 2007/08–2012/13 1/**

	2007/08	2008/09	2009/10	2010/11	2011/12 Proj.	2012/13 Proj.
Total revenue and grants	5,919	5,576	5,938	7,098	7,731	9,232
Net tax revenue	4,413	4,451	4,597	5,767	6,211	7,383
Nontax revenue 3/	1,478	1,097	1,310	1,304	1,499	1,825
Grants	27	28	31	27	22	25
Total expenditure and net lending	7,188	8,952	10,123	11,895	13,084	15,168
Current expenditure 4/	6,101	8,112	9,328	10,629	11,629	13,546
Capital expenditure and net lending 6/	1,088	840	795	1,266	1,455	1,621
Issuance of subsidy bonds	281	409	103	0	0	0
Overall balance (authorities' definition) 7/	-1,269	-3,370	-4,185	-3,697	-5,318	-5,526
Overall balance (IMF definition) 8/	-1,550	-3,785	-4,288	-4,797	-5,353	-5,935
Financing	1,269	3,376	4,185	4,797	5,353	5,935
External (net)	93	110	110	223	145	167
Domestic (net)	1,176	3,265	4,074	4,574	5,208	5,769
Total revenue and grants	12.0	10.0	9.1	9.0	8.6	9.0
Net tax revenue	8.9	8.0	7.0	7.3	6.9	7.2
Gross tax revenue	12.0	10.9	9.5	10.1	9.8	10.3
Of which: corporate tax	3.9	3.8	3.7	3.8	3.6	3.7
income tax	2.1	1.9	2.0	1.9	1.8	2.0
excise taxes	2.5	2.0	1.6	1.7	1.8	1.9
customs duties	2.1	1.8	1.3	1.7	1.6	1.6
other taxes	1.4	1.4	0.9	1.0	1.0	1.1
Less: States' share	3.1	2.9	2.5	2.8	2.9	3.1
Nontax revenue 3/	3.0	2.0	2.0	1.7	1.7	1.8
Grants	0.1	0.1	0.0	0.0	0.0	0.0
Total expenditure and net lending	14.5	16.1	15.5	15.1	14.5	14.8
Current expenditure 4/	12.3	14.6	14.2	13.5	12.9	13.2
Of which: interest payments	3.5	3.5	3.3	3.0	3.0	3.2
wages and salaries	0.9	1.3	1.4	1.2	1.1	1.1
subsidies 5/	1.4	2.3	2.1	2.1	2.0	2.3
of which: food	0.6	0.8	0.9	0.8	0.7	1.0
fertilizer	0.7	1.4	0.9	0.8	0.7	0.7
fuel	0.1	0.1	0.2	0.5	0.6	0.6
Capital expenditure and net lending 6/	2.2	1.5	1.2	1.6	1.6	1.6
Subsidy-related bonds 9/	0.6	0.7	0.2	0.0	0.0	0.0
Overall balance (authorities' definition) 7/	-2.6	-6.1	-6.4	-4.7	-5.9	-5.4
Overall balance (IMF definition) 8/	-3.1	-6.8	-6.5	-6.1	-5.9	-5.8
Financing	2.6	6.1	6.4	6.1	5.9	5.8
External (net)	0.2	0.2	0.2	0.3	0.2	0.2
Domestic (net)	2.4	5.9	6.2	5.8	5.8	5.6
Of which: market borrowing	2.7	4.2	6.1	4.3	5.2	4.7
small savings (net of states' share)	-0.1	0.1	0.4	0.4	0.2	0.3
divestment receipts	0.1	0.0	0.4	1.7	0.1	0.3
Memorandum items:						
Primary balance	0.9	-2.6	-3.1	-3.1	-3.0	-2.7
Current balance 7/	0.0	-4.6	-4.8	-2.8	-4.3	n.a.
Current balance (augmented) 8/	-0.6	-5.3	-5.0	-2.8	-4.3	n.a.
Central government debt 10/	59.4	59.3	55.5	50.8	50.2	49.1
Nominal GDP (in Rs. billion)	49,479	55,671	65,503	78,756	90,194	102,251

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

1/ Data for April - March fiscal years.

2/ Budgeted deficit was 5.6 percent of GDP under IMF definition; 5.1 percent under authorities' definition.

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

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

5/ Excludes subsidy-related bond issuance.

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

7/ Treats divestment as a revenue item until 2005/06 and after 2009/10 (included). In 2008/09, authorities treat proceeds from selling shares vested with SUTI as revenue in the Budget.

8/ Treats divestment receipts as a below-the-line financing item. Includes subsidy-related bond issuance as expenditure.

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

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

Table 6. India: General Government Operations, 2007/08–2012/13 1/

	2007/08	2008/09	2009/10	2010/11 Proj.	2011/12 Proj.	2012/13 Proj.
(In billions of rupees)						
Total revenue and grants	10,952.5	11,095.6	12,101.2	14,475.4	15,996.5	19,104.5
Tax revenue 4/	8,796.9	9,272.3	9,900.5	12,226.8	13,612.8	16,159.4
Nontax revenue 5/ 6/	2,128.4	1,795.4	2,169.3	2,221.9	2,361.9	2,920.4
Grants	27.2	27.9	31.4	26.7	21.7	24.6
Total expenditure and net lending 7/ 8/	12,867.7	15,682.3	18,507.2	21,374.2	23,327.3	26,957.2
Capital Expenditure	2,296.1	1,784.3	2,326.0	3,045.8	3,314.5	3,735.4
General government balance	-2,195.8	-4,995.6	-6,509.1	-6,898.8	-7,330.7	-7,852.8
Financing	1,915.2	4,586.7	6,406.0	6,898.8	7,330.7	7,852.8
External (net)	93.2	110.2	110.4	222.6	145.0	166.9
Domestic (net)	1,822.1	4,476.6	6,295.7	6,676.1	7,185.7	7,685.8
Disinvestment receipts	127.9	155.7	245.8	1,304.8	80.0	306.8
(In percent of GDP)						
Total revenue and grants	22.1	19.9	18.5	18.4	17.7	18.7
Tax revenue 4/	17.8	16.7	15.1	15.5	15.1	15.8
Nontax revenue 5/ 6/	4.3	3.2	3.3	2.8	2.6	2.9
Grants						
Total expenditure and net lending 7/ 8/	26.0	28.2	28.3	27.1	25.9	26.4
Capital Expenditure	4.6	3.2	3.6	3.9	3.7	3.7
General government balance	-4.4	-9.0	-9.9	-8.8	-8.1	-7.7
Domestic financing (net)	3.7	8.0	9.6	8.5	8.0	7.5
Memorandum items:						
Primary balance	1.4	-3.2	-4.9	-4.3	-3.8	-3.1
Nondefense capital expenditure	3.7	3.1	2.8	3.5	2.9	n.a.
Net interest payments	5.2	5.1	4.9	4.5	4.3	n.a.
State and union territory governments' balance 9/	-1.4	-2.1	-2.9	-2.7	-2.2	-2.0
Consolidation items 10/	0.1	0.1	0.0	0.1	0.0	0.0
Subsidy-related bond issuance	0.6	0.7	0.2	0.0	0.0	0.0
General government debt 11/	74.6	75.4	71.3	66.7	66.2	65.7

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

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

2/ Based on Revised Estimates from 2010/11 Budget.

3/ Staff forecasts based on 2010/11 Budget and subsequent supplementary demands for grants.

4/ Tax revenue equals tax revenue of central government (CG), including NCCF and states' share, plus state tax revenue.

5/ Nontax revenue equals nontax revenue of CG, less interest payments by states on CG loans, plus nontax revenue of states.

6/ In 2007/08, includes a special dividend payment from the RBI amounting to roughly 0.7 percent of GDP. The authorities include this item under "other capital receipts."

7/ Expenditure and net lending equals total expenditure and net lending of CG (authorities' definition excluding subsidy-related bonds), less net loans and grants to states and union territories, plus total expenditure of states (excluding interest payments on CG loans).

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

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

10/ Above-the-line items in the CGA, which cancel out in the consolidation (e.g., loans to states).

11/ 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: Indicators of External Vulnerability, 2007/08–2011/12 1/**

	2007/08	2008/09	2009/10	2010/11	2011/12 2/
<b>Financial indicators</b>					
General government debt (percent of GDP)	74.6	75.4	71.3	66.7	66.2 (Projection)
Broad money (percent change, 12-month basis)	21.4	19.3	16.8	16.0	15.6 (December 2011)
Private sector credit (percent change, 12-month basis)	21.1	16.9	15.8	21.3	15.6 (December 2011)
91 day T-bill yield (percent; end-period)	7.2	5.0	4.4	7.3	8.8 (January 2012)
91 day T-bill yield (real, percent; end-period) 3/	2.4	-2.9	0.5	-2.1	1.7 (January 2012)
<b>External indicators</b>					
Exports (percent change, 12-month basis in US\$) 4/ 5/	28.9	13.7	-3.5	37.3	9.5 (Projection)
Export volume (percent change, 12-month basis) 5/	18.4	8.4	-1.5	29.8	10.5 (Projection)
Imports (percent change, 12-month basis in US\$) 4/ 5/	35.1	19.8	-2.6	26.7	12.4 (Projection)
Import volume (percent change, 12-month basis) 5/	18.8	8.6	8.2	19.0	8.7 (Projection)
Terms of trade (percent change, 12 month basis) 5/	-3.4	-1.3	3.8	-2.1	-2.5 (Projection)
Current account balance (percent of GDP)	-1.3	-2.3	-2.8	-2.7	-2.8 (Projection)
Capital and financial account balance (percent of GDP)	8.7	0.6	3.7	3.6	3.1 (Projection)
<i>Of which</i> : Net portfolio investment (debt and equity)	2.2	-1.2	2.3	1.8	0.7 (Projection)
Other investment (loans, trade credits, etc.)	5.1	-0.1	0.1	1.3	1.4 (Projection)
Net foreign direct investment	1.3	1.8	1.3	0.5	1.1 (Projection)
Foreign currency reserves (billions of US\$)	309.7	252.0	279.1	293.1	298.6 (Projection)
Official reserves (in months of imports of goods and services)	10.3	8.4	7.2	6.8	5.7 (Projection)
Ratio of foreign currency reserves to broad money (percent)	30.8	26.8	22.5	20.9	21.7 (December 2011)
Total short-term external debt to reserves (percent) 6/	27.2	32.4	32.5	39.7	45.9 (Projection)
Total external debt (percent of GDP)	18.3	18.6	18.9	17.3	19.7 (Projection)
<i>Of which</i> : public sector debt	4.6	4.9	4.4	3.8	3.8 (Projection)
Total external debt to exports of goods and services (percent)	87.5	76.1	93.7	77.8	79.4 (Projection)
External interest payments to exports of goods and services (percent)	3.2	2.9	2.2	1.5	1.8 (Projection)
External amortization payments to exports of goods and services (percent)	14.5	12.5	13.7	11.2	12.0 (Projection)
Exchange rate (per US\$, period average)	40.3	46.0	47.4	45.6	51.0 (January 2012)
REER (y/y change in percent; end-period)	7.7	-4.8	3.1	14.3	-10.5 (December 2011)
<b>Financial market indicators</b>					
Stock market index (end-period)	15644.4	9708.5	17527.8	19445.2	17193.6 (January 2012)
Foreign currency debt rating					
Moody's Investor Services	Baa2	Baa2	Baa3	Baa3	Baa3 (January 2012)
Standard and Poor's	BBB-	BBB-	BBB-	BBB-	BBB- (January 2012)
Fitch Ratings	BBB-	BBB-	BBB-	BBB-	BBB- (January 2012)

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

1/ Data for April-March fiscal years.

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

3/ Equals nominal yield minus actual WPI core inflation.

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

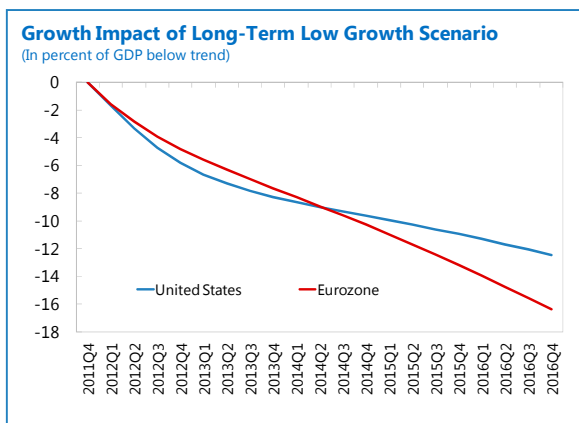
5/ Terms of trade including goods and services. Goods volumes are derived from partner country trade price deflators, and services volumes are derived using U.S. CPI from the WEO database.

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

## ANNEX I. THE EFFECTS OF EXTERNAL DOWNSIDE SCENARIOS ON INDIA<sup>1</sup>

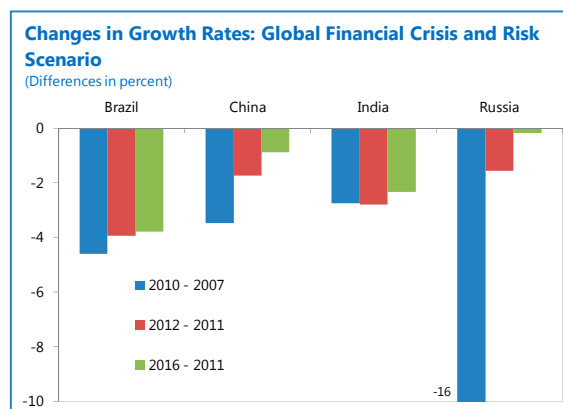
<sup>1</sup> Prepared by James P. Walsh.

**1. Using a model of 15 large economies, we assess the effects of a renewed period of global financial stress and slow global growth on the Indian economy.** The model is a panel unobserved components model covering 15 major economies that accounts for both trade and financial linkages, which is particularly important given likely transmission channels for India<sup>1</sup>. The simulation posits a renewed bout of financial turmoil in the United States and Europe followed by a protracted period of slow growth. Rising household savings rates and fiscal austerity, combined with a weak banking sector and financial difficulties pull advanced economies' growth below potential until 2016.



<sup>1</sup> The model is presented in Vitek, F. and T. Bayoumi, "Spillovers from the Euro Area Sovereign Debt Crisis: A Macroeconometric Model Based Analysis," CEPR Discussion Paper No. 8497. ([www.cepr.org/pubs/dps/DP8497.asp](http://www.cepr.org/pubs/dps/DP8497.asp)).

**2. For India and other EMs, this downside scenario generates a growth shock comparable to the global financial crisis (GFC).** In the major EMs, the shock to growth over the first year would be substantial, with Indian growth declining similarly to what happens in Brazil and China. Most EMs are not overheating now to the same degree they were in 2008, meaning their base rate of growth is now lower. Under the risk scenario, growth would thus fall well below potential, and due to prolonged high risk aversion, to lower levels than observed during the GFC. Finally, in the long run, due to the extent and importance of their financial linkages, Brazil and India show growth rates still below-pre-crisis levels even toward the end of the scenario.

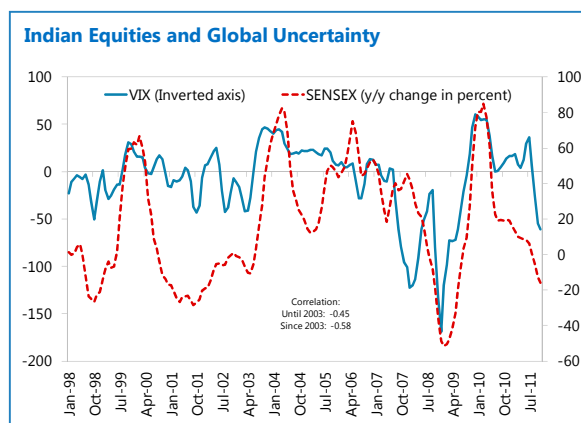




## India's Macroeconomic and Financial Linkages

### 3. India's trade would be affected by a global crisis but the net impact is unlikely to be large.

India is less exposed to global supply chain disruptions than many other Asian economies. While a 1 percent decline in global domestic demand (weighted by countries' trade with India) is associated with a 0.6 percent decline in Indian exports, this is likely to be countered by declining imports, as occurred during the GFC. A \$10 fall in global oil prices would improve India's current account deficit by around 0.6 percent of GDP, while falling investment would pull down imports of capital goods, which account for about 60 percent of imports.



### 4. On the other hand, investment would likely be severely affected.

Investment, particularly corporate investment, has become increasingly integrated with global trends, both through sentiment effects and through financial channels such as corporate external borrowing and equity markets. Around 11 percent of the market capitalization, and a significantly larger share of the free float, of India's equity markets is held by foreigners, the stock of external borrowing by Indian corporates is now around 4 percent of GDP, and total holdings of debt securities amount to 2.3 percent of GDP. Falling global investor confidence could thus have a serious impact on equity prices, the rupee, and capital flows, complicating rollover of existing debt or finance for new projects.

Table : Flow of Financial Resources to the Commercial Sector  
(In percent of total)

	April-March		April-December	
	2009-10	2010-11	2010-11	2011-12
Adjusted Non-food Bank Credit (NFC)	45	57	57	46
Flow from Non-banks (B1+B2)	55	43	43	54
Domestic Sources	34	24	24	28
Foreign Sources	21	19	19	26
External Commercial Borrowings / FCCBs	1	4	5	7
ADR/GDR Issues excluding banks and financial institutions	1	1	1	0
Short-term credit from abroad	3	4	3	3 1/
FDI to India 3/	15	10	10	17 2/
Total Flow of Resources (A+B)	100	100	100	100

Source: Reserve Bank of India.

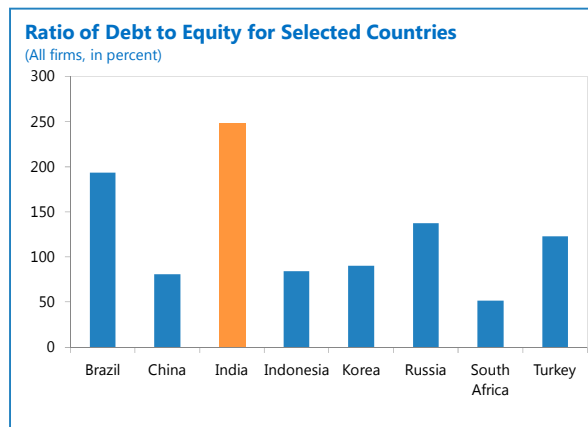
1/ Up to September, 2011.

2/ Up to November 2011.

3/ FDI Data include equity capital and reinvested earnings of incorporated entities & unincorporated entities for the period April-September.

## 5. The corporate sector also presents

**some risks.** Indian corporates are quite leveraged, with a debt to equity ratio in 2010 of 248 percent, above comparator countries, though medium- and long-term debt accounted for more than 55 percent of total debt, reducing immediate risks. CDS spreads for Indian companies have also risen recently, though they remain below levels seen in 2008/09. Also, corporates' rely on foreign sources for around a



quarter of financing, creating the potential for feedback loops between corporate vulnerabilities and external shocks.

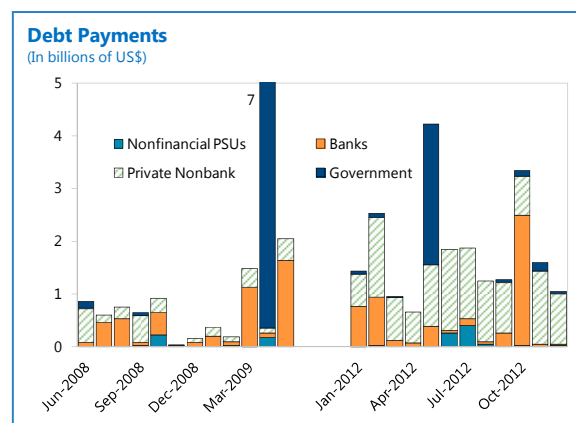
## 6. Bank stress tests run during the FSAP provide some guidance on how the financial system would be affected.

The FSAP ran stress tests based on macroeconomic scenarios involving global financial stress. In a situation comparable to the scenario above, banks' capital ratios could fall by around a third, and Tier 1 capital to only 2½ percent. NPAs could rise to 7-8 percent of total advances, a significantly bigger increase than observed during the GFC. Capitalization needs could rise to around 3½ percent of total system assets or 1¾ percent of GDP. At the same time, global uncertainty would complicate dollar borrowing by banks and corporates and could, as in 2008/09, lead to a

domestic liquidity crunch, though not one beyond the ability of the RBI to manage through its steadily improving liquidity framework.

**7. India's external position has also weakened somewhat since the GFC.** The net international investment position fell from -6 percent of GDP in March 2008 to -13 percent of GDP in September 2011. Short-term external debt rose from 27.2 to 39.7 percent of reserves between March 2008 and March 2011 (from 6.8 to 6.7 percent of GDP), while NRI deposits, traditionally a more stable source of financing, were relatively stable at 14.1 to 14.2 percent (and fell from 3.6 to 2.4 percent of GDP). India's external debt remains manageable at 19.7

percent of GDP and its duration has remained broadly stable since the GFC, though forecast debt service over the next two years is higher than during the run-up to the GFC, particularly when compared to a relatively constant stock of international reserves.





# INDIA

## STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 22, 2012

Prepared By

The Asia and Pacific Department

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## ANNEX I. INDIA: FUND RELATIONS

(As of December 31, 2011)

### I. Membership Status:

Joined December 27, 1945; Article VIII.

### II. General Resources Account

	SDR Million	% Quota
Quota	5,821.50	100.00
Fund holdings of currency	4,176.27	71.74
Reserve position in Fund	1,645.38	28.26
Lending to the Fund		
New arrangement to borrow		910.00

### III. SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	3,978.26	100.00
Holdings	2,884.84	72.52

### IV. Outstanding Purchases and Loans: None

### V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR millions)	Amount Drawn (SDR millions)
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	11/09/81	05/01/84	5,000.00	3,900.00

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

	Forthcoming				
	2012	2013	2014	2015	2016
Principal					
Charges/interest	1.39	1.26	1.26	1.26	1.26
<b>Total</b>	<b>1.39</b>	<b>1.26</b>	<b>1.26</b>	<b>1.26</b>	<b>1.26</b>

### VII. Exchange Rate Arrangement:

As per the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER), the exchange rate in India is classified as floating. The exchange rate of the rupee is determined in the interbank market, where the Reserve Bank of India (RBI) intervenes at times. The RBI's role is to modulate excessive volatility so as to maintain orderly conditions. On August 20, 1994, India accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement. India maintains the following restrictions on the making of payments and transfers for current

international transactions, which are subject to Fund approval under Article VIII, Section 2(a): restrictions related to the nontransferability of balances under the India-Russia debt agreement; restrictions arising from unsettled balances under inoperative bilateral payments arrangements with two Eastern European countries; and a restriction on the transfer of amortization payments on loans by non-resident relatives. The Executive Board has not approved these restrictions.

#### VIII. **Article IV Consultation:**

The previous Article IV consultation discussions were held in November 2010. The staff report (IMF Country Report No. 11/50) was discussed by the Executive Board on December 22, 2010.

#### IX. **FSAP Participation and ROSCs:**

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

#### X. **Technical Assistance:**

<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

#### XI. **Outreach and Other Activities:**

<b>Dept</b>	<b>Purpose</b>	<b>Date of Delivery</b>
APD	Book: <i>India: Managing Financial Integration and Growth</i>	6/08
APD	Seminar: "Have We Seen this Movie Before? Comparing The Crisis of 2008 with East Asia 1998", presented at ICRIER/IM-Welt conference and Yale Initiative on Asian and International Relations	11/08
APD	Seminar: "Forecasting Growth and Inflation: China and India", presented in New Delhi	10/09
APD	Seminars: "What are the Effects of Fiscal Policy Shocks in India?" and "The global Financial Crisis: Explaining cross-country differences in the output impact", presented at the 6 <sup>th</sup> NIPFP-DEA Research Conference, New Delhi	03/10
APD	Seminars: "Revisiting the Inflation-Output Trade-Off in India" and "Corporate Investment in India," presented at the Madras School of Economics.	01/12

#### XII. **Resident Representative:**

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

## ANNEX II. INDIA—RELATIONS WITH THE WORLD BANK GROUP

In Bank FY2011 (July 1-June 30), IBRD/IDA lending totaled US\$3.47 billion. IFC committed \$754 million in FY2011. The World Bank Group's (WBG) Country Strategy (CAS) for India for 2009-2012 focuses on helping India to fast-track the development of much-needed infrastructure and to support the seven poorest states in achieving higher standards of living for their people. The strategy envisaged a total proposed International Bank for Reconstruction and Development (IBRD) lending program of US\$14.6 billion for the four-year CAS period, of which approximately US\$3 billion additional IBRD financing was in response to the financial crisis. The International Development Association (IDA) 15 allocation was SDR 2.919 billion (US\$ equivalent 4.79 billion). Midway through CAS implementation the projected IBRD lending was revised upward to US\$16 billion. India's IDA 16 allocation is SDR 3,243.6 billion US\$ equivalent 5.019 billion).

As a result of the financial crisis as well as increased Government demand for the Bank Group's support, the pace of IBRD lending accelerated in FY10-11, bringing India closer to its Single Borrower Limit (SBL) of \$17.5 billion earlier than anticipated. To help maintain India's IBRD net exposure within the SBL and ensure medium-term sustainability of the India program, the Reserve Bank of India is discussing an agreement with the IBRD and the Bank for International Settlements on purchases of IBRD Special Private Placement Bonds. The IBRD and Government are working to increasing the selectivity of new projects and scaling up efforts to leverage private finance with IBRD investments. India is IFC's largest country exposure. IFC is focusing on projects with development impact and is managing its exposure via mobilization and selectivity.

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

The World Bank's India Program is increasingly focused on supporting large, transformative development programs, with projects such as the National Ganga River Basin, Pradhan Mantri Gram Sadak Yojana (PMGSY) Second Rural Roads, and National Rural Livelihoods, and innovative operations such as the Karnataka Watershed. The shift to a more substantial engagement has raised the visibility and influence of the Bank Group, while creating opportunities for greater focus on public policy and institutional reform.

**India: World Bank Financial Operations**

	(In millions of U.S. dollars) <sup>1/</sup>
	2010/11
<b>Commitments 2/</b>	<b>5,550</b>
IBRD	2,433
IDA	3,117
<b>Disbursement</b>	<b>4,682</b>
IBRD	3,333
IDA	1,349
<b>Repayments</b>	<b>1,632</b>
IBRD	648
IDA	984
<b>Debt outstanding and disbursed</b>	<b>38,320</b>
IBRD	11,304
IDA	27,016

Source: World Bank.

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

2/ Based on loan approval date.



## ANNEX III. INDIA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK

The Asian Development Bank (AsDB) operations in India began in 1986. Cumulative public sector loan commitments totaled \$25.3 billion as of 31 December 2011 for 159 loans. With an additional \$1.9 billion in private sector loans (the latter without government guarantee), total loan commitments on a cumulative

basis amount to \$27.2 billion. These funds have been provided from AsDB's ordinary capital resources (OCR). Also, AsDB has approved equity investments amounting to \$0.3 billion. AsDB's lending and equity activities are summarized below.

India: Asian Development Bank Financial Operations (sovereign and non-sovereign)  
(In millions of U.S. dollars, as of 31 December 2011)

Calendar Year	OCR Loan Private Commitments	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
<b>Total</b>	<b>27,224.7</b>	<b>297.5</b>	<b>16,959.7</b>

Source: Asian Development Bank.

AsDB's India Country Partnership Strategy (2009-2012) (CPS) is based on four strategic pillars: (i) Support for the process of inclusive and environmentally sustainable growth; (ii) Catalyzing investment through the use of innovative business and financing modalities; (iii) Strengthening the results orientation of project design and implementation and emphasizing knowledge solutions; and (iv) Support for regional cooperation. The CPS has been designed to support Government of India's efforts in facilitating inclusive growth and speeding up the pace of poverty reduction and social development as emphasized in the Eleventh Five-Year

Plan (2007-2012). It has been prepared within a results-based framework, and aims at significantly strengthening AsDB support for infrastructure development in the relatively poorer states of India, promoting public private partnerships in infrastructure, supporting climate change adaptation and mitigation, and encouraging the use of innovative financing modalities (non-sovereign loans and cofinancing) to enhance the leverage of AsDB operations.

## ANNEX IV. STATISTICAL ISSUES

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

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

3. **National accounts and employment statistics:** The Central Statistical Organization (CSO) releases a new series of national accounts, with base year 2004–2005 with a dissemination lag for quarterly releases of two months. 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 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 nonmanual 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. Despite recent progress, real estate and housing price data are not available on a timely basis and the geographic coverage remains limited.

5. **External sector statistics:** While the concepts and definitions used to compile

balance of payments statistics are broadly in line with the fifth edition of the Balance of Payments Manual (BPM5), the RBI presentation does not strictly follow the BPM5. Furthermore, trade data have quality, valuation, timing, and coverage problems, and data on trade prices, volumes, and composition are not regularly available on a timely basis. Only trade credit extended for more than 180 days is included in the balance of payments (and the IIP and external debt data); trade credit is often less than 180 days in most countries. Bilateral data on services exports to the United States and other developed countries are manifold higher than counterpart services imports published by these same countries. External debt statistics are available on a quarterly basis with a one quarter lag. Estimates of short-term external debt are presented in the debt statistics on an original maturity basis. The short-term maturity attribution on a residual maturity basis is only available annually (and excludes residual maturity of medium- and long-term nonresident Indian accounts). The international investment position (IIP) statistics cover the sectors prescribed in the BPM5 and these data are disseminated within six months of the reference period in respect of annual data. Coverage of direct investment positions data is hampered by the absence of appropriate legal or institutional authority. India began disseminating the Data Template on International Reserves and Foreign Currency

Liquidity as prescribed under the SDDS in December 2001. The more up-to-date information on certain variables, such as total foreign reserves, foreign currency assets, gold, and SDRs, are available on a weekly basis and are disseminated as part of a weekly statistical supplement on the RBI web site.

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

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

corporations, and other resident sectors). Second, commercial banks add accrued interest to credit and deposit positions on a quarterly basis only (instead of the prescribed monthly basis).

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

9. **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. However, no monthly data on fiscal performance at the state level are available. 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 January 31, 2012

	Date of latest observation	Date received	Frequency of Data 1/	Frequency of Reporting 1/	Frequency of Publication 1/	Memo Items 2/	
						Data quality-Methodological soundness 2/	Data Quality-Accuracy and reliability 3/
Exchange Rates	01/31/12	01/31/12	D	D	D		
International reserve assets and reserve liabilities of the monetary authorities 4/	01/20/12	01/30/12	W	W	W		
Reserve/base money	01/20/12	01/30/12	W	W	W	O, O, LO, LO	O, O, O, O, O
Broad money	01/13/12	1/30/12	W	W	W		
Central bank balance sheet	Dec. 2011	1/20/12	M	M	M		
Consolidated balance sheet of the banking system	Dec. 2011	1/20/12	M	M	M		
Interest rates 5/	01/25/12	01/30/12	D	D	D		
Consumer price index	Dec. 2011	1/31/12	M	M	M	O, LNO, O, O	LNO, LO, O, O, O
Revenue, expenditure, balance and composition of financing - General Government 6/ 7/	2010/11	12/30/11	A	A	A	LNO, LO, O, O	O, O, O, O, LO
Revenue, expenditure, balance and composition of financing - Central Government 6/ 7/	Dec.2011	1/31/12	M	M	M		
Stocks of central government and central government-guaranteed debt 8/	2010/11	12/30/11	A	A	A		
External current account balance	Sept. 2011	1/13/12	Q	Q	Q	LO, O, LO, O	LO, O, O, O, LO
Exports and imports of goods and services	Sept. 2011	1/13/12	Q	Q	Q		
GDP/GNP	Sept. 2011	11/30/11	Q	Q	Q	LO, LNO, LO, LO	LNO, LNO, O, O, LO
Gross external debt	Sept. 2011	12/30/11	Q	Q	Q		
International Investment Position	Mar.2011	8/26/11	Q	Q	Q		

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

2/ Reflects the assessment provided in the data ROSC (published on April 2, 2004, and based on the findings of the mission that took place during May 13-30, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

3/ Same as footnote 2, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs and revision studies.

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

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

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

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

8/ Including currency and maturity composition



# INDIA

## STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

February 22, 2012

Approved By  
**Masahiko Takeda**  
**And Tamim Bayoumi**

Prepared by the Staff Representatives for the 2012  
Consultation with India

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## ANNEX I. INDIA: MEDIUM-TERM SUSTAINABILITY ANALYSIS

**Macroeconomic Assumptions.** Growth is forecast at 7 percent in 2012/13, and is expected to revert only gradually to trend growth of around 7½ - 8 percent in the medium term. Inflation (WPI) is expected to be around 7 percent in the year to March 2012, but with little decline expected thereafter.

**Fiscal Assumptions.** The rapid consolidation called for in early 2010 has proved challenging. The 2011/12 general government deficit is forecast at 8.1 percent of GDP. While state budget deficits are largely contained, deficits at the central level are likely to decline only slowly.

- Tax revenues remain well below historical levels of GDP due to slowing corporate revenues, cuts to fuel taxes, and a failure to reverse the 2009 tax cuts taken to stimulate the economy. Buoyancy has been modest since the end of the global financial crisis (GFC); combined with the clouded outlook for tax reform, consolidation based on revenue is unlikely<sup>1</sup>.
- Expenditure in three of the four areas targeted by the government for consolidation (interest, wages and pensions), as well as military and Plan expenditure, are expected to remain under control and support consolidation.
- The fourth area, subsidies, continues to grow rapidly. Reforms to fertilizer pricing have not brought down subsidy payments, and diesel prices are now around one-third

percent below international prices as they were raised only once in the first 11 months of 2011/12. Without significant reform this will continue to weigh on the budget.

### A. Sensitivity Analysis

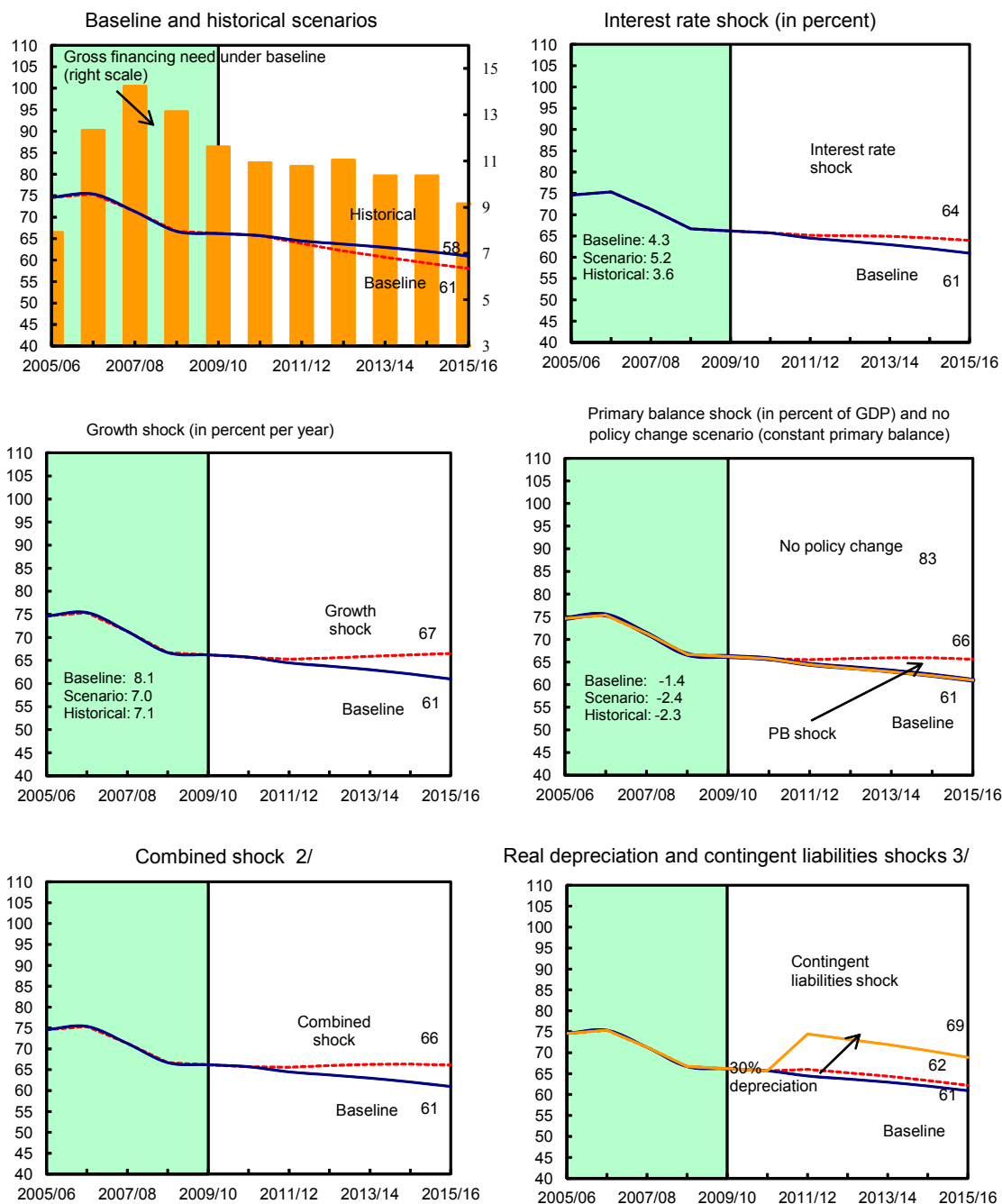
**Debt Path under the baseline.** The primary deficit is expected to remain around 3 percent over the medium term, slightly below the debt-stabilizing level as interest rates remain well below GDP growth. The ratio of debt to GDP is thus likely to decline steadily from 66¼ percent at end-2011/12 to 61.4 percent in 2017/18.

**Other Scenarios.** With deficits close to the debt-stabilizing level, a scenario of no policy change produces constant dynamics. Nominal GDP growth averaging around 14 percent reduces the impact of most shocks, so shocks to interest rates or contingent liabilities would have only a transient effect on debt dynamics, though one with slower growth would produce a slowly rising debt ratio.

**Policy Risks.** A return to fiscal consolidation involving serious subsidy reform would bring India closer to last year's analysis of a more rapid decline in the debt ratio. On the other hand, a big increase in spending in the buildup to the 12<sup>th</sup> Plan or a large stimulus to revive a slowing economy could produce significantly less favorable dynamics.

<sup>1</sup> The DTC and GST have both been delayed, but in any case are likely to be revenue neutral in the near term.

**Figure I.1. India: Public Debt Sustainability: Bound Tests 1/**  
(Public debt, in percent of GDP)



Source: Fund staff estimates; fiscal year data.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).



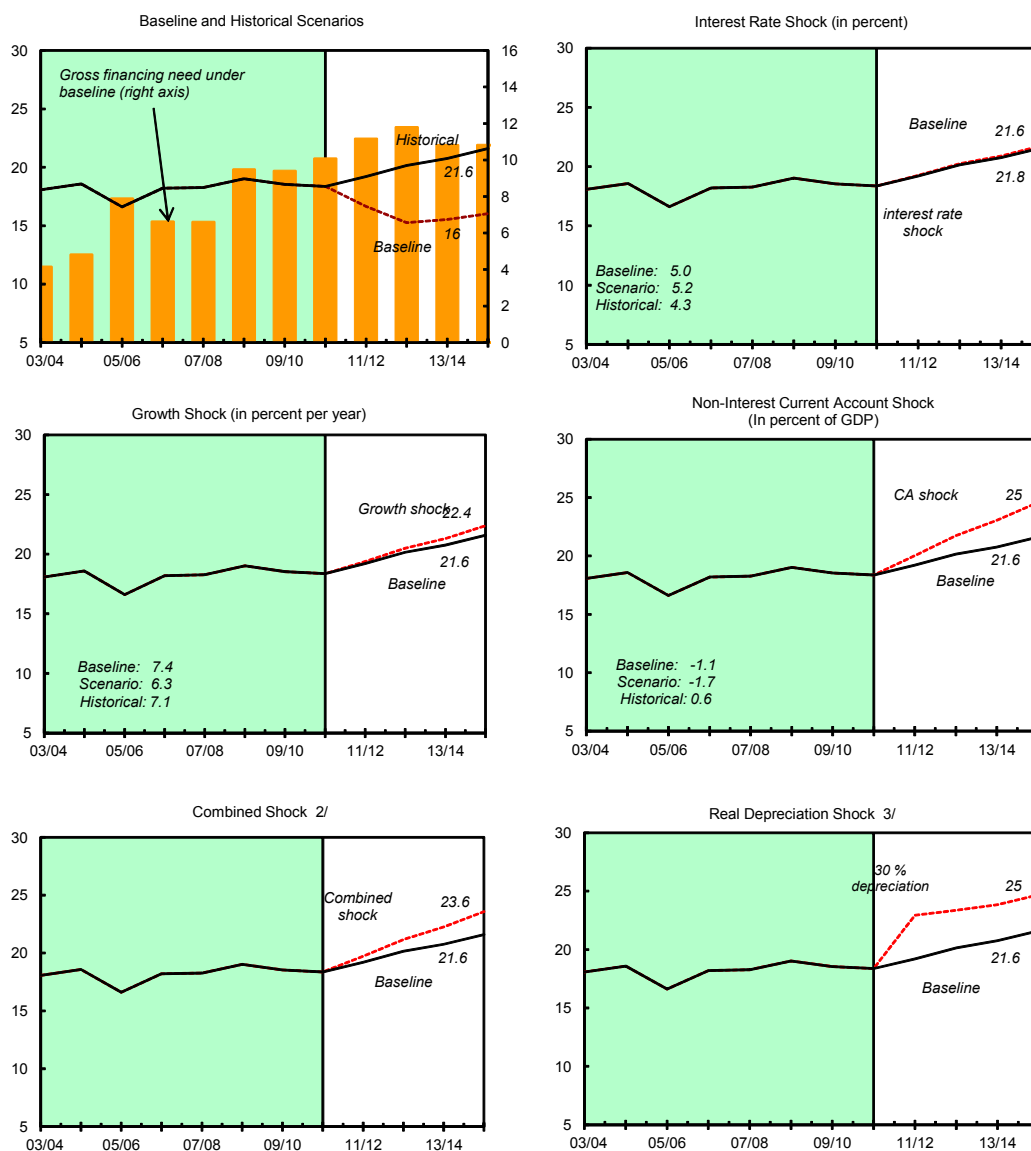
Table I.2. India: Public Sector Debt Sustainability Framework, 2007/08-2017/18  
(In percent of GDP, unless otherwise indicated)

	Actual										Projections							Debt-stabilizing primary balance 9/
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23		
<b>Baseline: Public sector debt 1/</b>	74.6	75.4	71.3	66.7	66.2	65.7	64.5	63.7	63.0	62.1	61.0	61.0	61.0	61.0	61.0	61.0	61.0	
o/w foreign-currency denominated	4.3	4.8	3.8	3.6	3.3	3.0	2.8	2.6	2.4	2.3	2.1	2.1	2.1	2.1	2.1	2.1	2.1	
Change in public sector debt	-2.7	0.8	-4.1	-4.6	-0.5	-0.5	-1.2	-0.7	-0.8	-0.9	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	
Identified debt-creating flows (4+7+12)	-6.6	1.1	-1.6	-1.6	0.4	0.3	-0.4	0.1	-0.3	-0.4	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	
Primary deficit	-1.4	3.2	4.9	4.3	3.8	3.0	3.1	3.1	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	
Revenue and grants	22.1	19.9	18.5	18.4	17.7	18.7	18.8	18.9	18.9	19.0	19.1	19.1	19.1	19.1	19.1	19.1	19.1	
Primary (noninterest) expenditure	20.8	23.1	23.4	22.7	21.5	21.7	21.9	22.0	21.9	21.9	22.1	22.1	22.1	22.1	22.1	22.1	22.1	
Automatic debt dynamics 2/	-5.5	-2.1	-7.0	-7.6	-3.5	-3.2	-3.9	-3.4	-3.5	-3.7	-3.8	-3.8	-3.8	-3.8	-3.8	-3.8	-3.8	
Contribution from interest rate/growth differential 3/	-5.1	-3.2	-6.5	-4.1	-4.1	-3.2	-3.9	-3.4	-3.5	-3.7	-3.8	-3.8	-3.8	-3.8	-3.8	-3.8	-3.8	
Of which contribution from real interest rate	1.3	0.0	-0.5	-2.3	-0.2	0.9	0.3	0.9	0.8	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	
Of which contribution from real GDP growth	-6.4	-3.2	-5.9	-5.2	-3.9	-4.1	-4.2	-4.3	-4.4	-4.4	-4.4	-4.4	-4.4	-4.4	-4.4	-4.4	-4.4	
Contribution from exchange rate depreciation 4/	-0.4	1.1	-0.5	0.0	0.7	...	...	...	...	...	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.3	0.0	0.4	1.7	0.1	0.4	0.4	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	
Privatization receipts (negative)	0.1	0.0	0.4	1.7	0.1	0.4	0.4	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	
Recognition of implicit or contingent liabilities	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	3.9	-0.3	-2.4	-3.0	-0.9	-0.8	-0.8	-0.8	-0.8	-0.8	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	
Public sector debt-to-revenue ratio 1/	337.1	378.2	385.9	362.8	373.2	351.6	343.1	337.9	333.2	327.3	319.1	319.1	319.1	319.1	319.1	319.1	319.1	
<b>Gross financing need 6/</b>	7.9	12.3	14.2	13.1	11.6	10.9	10.8	11.0	10.4	10.4	9.2	9.2	9.2	9.2	9.2	9.2	9.2	
in billions of U.S. dollars	97.2	149.0	196.5	227.0	198.8	202.9	221.6	250.2	258.9	285.6	278.9	278.9	278.9	278.9	278.9	278.9	278.9	
<b>Scenario with key variables at their historical averages 7/</b>																		
<b>Scenario with no policy change (constant primary balance) in 2012/13-2017/18</b>																		
<b>Key Macroeconomic and Fiscal Assumptions Underlying Baseline</b>																		
Real GDP growth (in percent)	9.6	4.9	9.3	8.8	6.7	7.0	7.4	7.6	7.8	7.9	8.1	8.1	8.1	8.1	8.1	8.1	8.1	
Average nominal interest rate on public debt (in percent) 8/	7.8	7.7	7.6	7.5	7.5	8.0	7.8	7.6	7.4	7.3	7.1	7.1	7.1	7.1	7.1	7.1	7.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.5	0.4	-0.1	-3.0	0.1	2.0	1.0	2.0	1.9	1.7	1.6	1.6	1.6	1.6	1.6	1.6	1.6	
Nominal appreciation (increase in US dollar value of local currency, in percent)	9.1	-21.3	12.6	1.1	-16.5	...	...	...	...	...	...	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	5.3	7.3	7.7	10.5	7.4	5.9	6.7	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	
Growth of real primary spending (deflated by GDP deflator, in percent)	13.1	16.5	10.8	5.4	1.3	8.0	8.2	8.0	7.5	7.9	8.7	8.7	8.7	8.7	8.7	8.7	8.7	
Primary deficit	-1.4	3.2	4.9	4.3	3.8	3.0	3.1	3.1	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	

1/ General government (Center and States); debt refers to gross debt.  
 2/ Derived as  $[(1+r)(1+g) - g + \alpha(1+\pi)] / (1+g+\pi-g\pi)$  times previous period debt ratio, with  $r$  = interest rate;  $\pi$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;  $\alpha$  = share of foreign-currency denominated debt; and  $\alpha$  = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).  
 3/ The real interest rate contribution is derived from the denominator in footnote 2/ as  $r - \pi(1+g)$  and the real growth contribution as  $-g$ .  
 4/ The exchange rate contribution is derived from the numerator in footnote 2/ as  $\alpha(1+\pi)$ .  
 5/ For projections, this line includes exchange rate changes.  
 6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.  
 7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.  
 8/ Derived as nominal interest expenditure divided by previous period debt stock.  
 9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

# ANNEX II. MEDIUM-TERM EXTERNAL DEBT SUSTAINABILITY ANALYSIS

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



Source: Fund staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

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

3/ One-time real depreciation of 30 percent occurs in 2010/11.

Table II.1. India: External Debt Sustainability Framework, 2005/06–2016/17

	(In percent of GDP, unless otherwise indicated)										Debt-stabilizing non-interest current account 6/ -4.2	
	Actual					Projections						
	05/06	06/07	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15	15/16	16/17
Baseline: external debt	16.6	18.2	18.3	19.0	18.5	18.4	19.2	20.2	20.8	21.6	22.4	23.2
Change in external debt	-2.0	1.6	0.1	0.8	-0.5	-0.2	0.8	0.9	0.6	0.8	0.8	0.8
Identified external debt-creating flows (4+8+9)	-3.2	-2.5	-6.1	0.9	-2.4	-1.8	-0.1	-0.2	-2.0	-2.3	-2.7	-3.0
Current account deficit, excluding interest payments	0.6	0.4	0.6	1.6	2.3	2.9	3.3	3.2	1.7	1.2	0.7	0.6
Deficit in balance of goods and services	3.4	3.4	4.3	5.4	6.0	6.8	7.0	6.7	5.0	4.5	4.1	3.7
Exports	19.4	21.4	20.9	24.3	20.1	21.5	22.4	23.7	24.3	25.0	25.7	26.4
Imports	22.9	24.8	25.2	29.7	26.1	28.2	29.4	30.4	29.3	29.5	29.8	30.1
Net nondebt creating capital inflows (negative)	-1.9	-1.6	-3.5	-0.5	-3.7	-3.7	-2.5	-2.6	-2.9	-2.9	-2.9	-2.9
Net foreign direct investment, equity	0.4	0.8	1.3	1.6	1.4	1.6	1.3	1.3	1.5	1.5	1.5	1.5
Net portfolio investment, equity	1.5	0.7	2.2	2.2	2.3	2.1	1.2	1.2	1.4	1.4	1.4	1.4
Automatic debt dynamics 1/	-1.9	-1.4	-3.2	-0.2	-1.1	-1.1	-0.9	-0.8	-0.7	-0.6	-0.5	-0.7
Denominator: 1+g+r+gr	1.2	1.1	1.3	1.0	1.1	1.2	1.1	1.1	1.1	1.1	1.1	1.1
Contribution from nominal interest rate	0.6	0.6	0.7	0.7	0.4	0.4	0.4	0.6	0.7	0.9	1.1	1.0
Contribution from real GDP growth	-1.5	-1.4	-1.4	-0.9	-1.5	-1.5	-1.3	-1.4	-1.5	-1.5	-1.6	-1.6
Contribution from price and exchange rate changes 2/	-1.0	-0.6	-2.5	...	...	...	...	...	...	...	...	...
Residual, including change in gross foreign assets (2-3) 3/	1.2	4.1	6.2	-0.1	2.0	1.7	0.9	1.2	2.6	3.2	3.5	3.8
External debt-to-exports ratio (in percent)	85.4	85.0	87.5	78.2	92.1	85.6	85.7	85.0	85.5	86.5	87.3	88.0
Gross external financing need (in billions of U.S. dollars) 4/	65.9	62.6	81.0	114.9	129.7	160.6	194.5	224.5	229.0	253.0	281.4	311.1
In percent of GDP	7.9	6.6	6.6	9.5	9.4	10.1	11.2	11.8	10.8	10.8	10.9	10.9
Scenario with key variables at their historical averages 5/							16.7	15.3	15.5	16.0	16.6	17.2
Key macroeconomic assumptions underlying baseline												
Real GDP growth at market prices (in percent)	9.3	9.4	9.6	5.1	9.1	9.2	8.0	7.9	8.1	8.1	8.1	8.1
GDP deflator in US dollars (change in percent)	6.2	3.3	18.3	-6.0	4.3	5.7	1.4	1.1	3.0	2.1	2.1	2.1
Nominal external interest rate (in percent)	3.9	4.0	4.7	3.8	2.7	2.2	2.6	3.2	4.1	4.8	5.6	4.7
Growth of exports goods and services (U.S. dollar terms, in percent)	26.7	24.5	26.6	15.0	-5.8	23.0	14.4	15.4	14.1	13.5	13.4	13.4
Growth of imports goods and services (U.S. dollar terms, in percent)	30.5	22.7	31.6	16.6	0.0	24.7	11.0	12.8	7.5	11.1	11.4	11.5
Current account balance, excluding interest payments	-0.6	-0.4	-0.6	-1.6	-2.3	-2.9	-3.3	-3.2	-1.7	-1.2	-0.7	-0.6
Net non-debt creating capital inflows	1.9	1.6	3.5	0.5	3.7	3.7	2.5	2.6	2.9	2.9	2.9	2.9
B. Bound Tests												
B1. Nominal interest rate is at historical average plus one standard deviation						18.4	19.3	20.2	20.9	21.8	22.6	23.5
B2. Real GDP growth is at historical average minus one standard deviation						18.4	19.4	20.5	21.3	22.4	23.5	24.5
B3. Non-interest current account is at historical average minus one standard deviation						18.4	20.0	21.7	23.0	24.6	26.1	27.5
B4. Combination of B1-B3 using 1/2 standard deviation shocks						18.4	19.7	21.2	22.3	23.6	24.9	26.2
B5. One time 30 percent real depreciation in 2010						18.4	22.9	23.4	23.8	24.7	25.6	26.6

Source: Fund staff estimates.

1/ Derived as  $[r - g - \rho(1+g)] / (1+g+p+gp)$  times previous period debt stock, with  $r$  = nominal effective interest rate on external debt;  $\rho$  = change in domestic GDP deflator in U.S. dollar terms;  $g$  = real GDP growth rate;  $e$  = nominal appreciation (increase in dollar value of domestic currency), and  $a$  = share of domestic-currency denominated debt in total external debt.2/ The contribution from price and exchange rate changes is defined as  $[-\rho(1+g) + ea(1+r)] / (1+g+p+gp)$  times previous period debt stock,  $\rho$  increases with an appreciating domestic currency ( $e > 0$ ) and rising inflation (based on GDP deflator).

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

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period. Short-term debt includes all the outstanding non-resident deposit accounts.

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

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

**Statement by the IMF Staff Representative on India**  
**March 9, 2012**

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. **The latest national accounts data confirmed the broad based slowdown, but there are signs of a modest rebound.** GDP growth dropped to 6.1 percent y/y in 2011Q4 (6.8 percent in 2011 Q3), in line with staff projections. Investment remains sluggish with a third consecutive decline in y/y terms. Private consumption was robust at 6.4 percent y/y. From the supply side, the slowdown was mostly due to manufacturing (which grew by 0.8 percent y/y, versus 2.7 percent in the previous quarter), while services continued to advance at a robust pace. In sequential terms, however, activity seems to have bottomed out. After rebounding strongly since late 2011, the manufacturing and services PMIs stabilized in February and remained well above the expansionary threshold.
2. **The trade deficit rose to \$14.8 billion in January (compared with \$10.3 billion in the previous year), owing to the jump in imports.** Import growth reached 20.3 percent y/y, partly due to higher oil prices, while non-oil imports growth moderated to 17.6 percent. Exports have also picked up steam, advancing by 10.1 percent y/y, following single digit growth in late 2011.
3. **In line with staff projections, inflation pressures have continued to abate on base effects.** The new national CPI (which was introduced last year) recorded an inflation rate of 7.7 percent y/y, while consumer price inflation for industrial workers fell sharply to 5.3 percent y/y due to the retrenchment in food prices. In sequential terms, the CPI-IW inflation momentum has also moderated.
4. **The rupee has appreciated and capital inflows have returned in recent weeks.** The rupee has appreciated by 8 percent against the U.S. dollar so far this year, with the NEER appreciating by about 5 percent. Portfolio equity inflows (mutual funds and ETFs) have rebounded significantly since late January.



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## **IMF Executive Board Concludes 2012 Article IV Consultation with India**

On March 9, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the 2012 Article IV consultation with India.<sup>1</sup>

### **Background**

India's growth remains one of the highest in the world, but a range of factors have weighed it down. Following a rapid recovery after the global financial crisis, the economy has slowed more than most other major emerging markets, as investment has been dampened by a confluence of cyclical and global factors, as well as by concerns about structural impediments. Consumption, particularly in rural areas, and exports, with increasing geographical destination diversity and sophistication, have been the bright spots. At the same time, inflation is elevated, and its recent moderation is primarily due to base effects. While monetary policy has been tightened, the fiscal deficit remains high. The unsettled global outlook has added to policy challenges. After the boom in capital inflows in 2010/11, rising global risk aversion has reduced the flow of capital. The rupee depreciated the most among major Asian currencies in 2011, partly due to India's current account deficit. Concerns about global growth have harmed investor sentiment and advanced economies' bank deleveraging has raised the cost of external finance.

Growth is projected at about 7 percent for 2011/12 and 2012/13, with inflation forecast to remain above the RBI's comfort zone. Investment is anticipated to pick up modestly from the slump recorded in late 2011, and consumption should remain robust, but exports are expected to cool.

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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. 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>.

Inflation is projected to fall in the near term, but to stay above the Reserve Bank of India's objective. The current account is projected at 2.8 percent of GDP.

Growth risks are to the downside. The main domestic risk is a further weakening of private investment if government approvals do not accelerate, reform efforts are not reinvigorated, and inflation remains high and volatile. At the same time, external risks continue to be elevated as Euro area growth could underperform and bank deleveraging could intensify even in the absence of a new full-fledged global financial crisis. Inflation risks remain, as momentum indicators are mixed.

### **Executive Board Assessment**

Executive Directors noted that sound macroeconomic policies and fundamentals enabled India to weather well the global economic crisis. Nevertheless, economic growth has slowed below trend in the last year due to cyclical and structural factors, and while inflation has come down, it is still high. Some Directors noted that it is difficult to attribute the current slowdown to structural factors. Downside risks prevail in light of the uncertain global environment, supply constraints and elevated funding costs. A major challenge will be to bring growth back to potential and ensure its inclusiveness, while further lowering inflation. Directors underscored that this will require a reinvigoration of structural reforms and fiscal consolidation.

Directors encouraged continued vigilance against inflation. They agreed that policy rates should be kept unchanged until inflation is clearly on a downward trend, given the uncertain outlook for growth. They encouraged the Reserve Bank of India to stand ready to raise policy rates if inflation starts to rise again, while it could consider cutting rates if the inflation momentum clearly eases.

Directors stressed that fiscal consolidation is crucial to crowd in private investment and lower inflationary expectations. They supported the planned reorientation of expenditure toward infrastructure and the social sectors, and highlighted the need to rationalize fuel and fertilizer subsidies and improve public expenditure management. They encouraged tax reform, especially the introduction of the goods and services tax.

Directors considered the flexible exchange rate regime to be an important buffer against external shocks, and supported the policy of intervening in the foreign exchange market only to contain volatility and to prevent disruptive movements. They welcomed the authorities' moves toward further trade and gradual capital account liberalization.

Directors underscored the importance of structural reform to raise public and private investment and boost inclusive growth. While some progress has been made, many Directors were of the view that a more determined effort to remove structural impediments is required in several areas. On the other hand, some Directors felt that structural reforms were progressing at a measured pace. Continuing to develop infrastructure, which in turn requires facilitating land acquisition and mining, would ensure that India's growth potential remains intact. Financial

sector development and reform are needed to improve access to credit and diversify funding sources. Addressing skill mismatches, increasing labor market flexibility, and improving agricultural productivity are crucial to support formal job creation and reduce poverty.

Directors welcomed the FSSA's finding that India's financial system is broadly stable, albeit with room for improvement in the regulatory and supervisory framework, and encouraged development of a prioritized action plan to implement key recommended reforms. They welcomed measures to increase the quantity and quality of bank capital, strengthen inter-regulatory cooperation, and clarify supervisory responsibilities. They encouraged close monitoring of asset quality and provisioning; continued development of domestic bond markets; a gradual reduction of credit concentration limits, with due regard to development needs for financing, and a reduction in mandatory holdings of government securities by financial institutions, while ensuring adequate liquidity buffers for financial stability.

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

## India: Selected Economic Indicators, 2007/08–2012/13 1/

## I. Social Indicators

GDP (2010/11)		Poverty (Percent of population)	
Nominal GDP (billions of U.S. dollars):	1,684	Headcount ratio (2005):	37.2
GDP per capita (U.S. dollars):	1,420	Undernourished (2000):	19.0
Population characteristics (2010)		Income distribution (2005, WDI)	
Total (in billions):	1.2	Richest 10 percent of households:	31.1
Urban population (percent of total):	31	Poorest 20 percent of households:	8.1
Life expectancy at birth (years):	65	Gini index:	36.8

## II. Economic Indicators

	2007/08	2008/09	2009/10	2010/11 Prel.	2011/12 Est.	2012/13 Proj.	2/
Growth (y/y percent change)							
Real GDP (at factor cost)	9.3	6.7	8.4	8.4	6.8	7.0	
Real GDP (at factor cost, calendar year basis)	9.4	7.3	8.0	8.4	6.8	7.1	
Industrial production	15.5	2.5	5.3	8.2	...	...	
Prices (y/y percent change, average)							
Wholesale prices (2004/05 weights)	4.7	8.1	3.8	9.6	8.7	7.2	
Wholesale prices (2004/05 weights, end of period)	7.7	1.6	10.4	9.7	6.8	7.0	
Consumer prices - industrial workers (2001 weights)	6.2	9.1	12.4	10.4	8.1	8.5	
Saving and investment (percent of GDP)							
Gross saving 2/	36.4	31.7	33.5	31.3	31.3	30.4	
Gross investment 2/	37.7	34.0	36.3	34.0	34.0	33.4	
Fiscal position (percent of GDP) 3/							
Central government deficit	-3.1	-6.8	-6.5	-6.1	-5.9	-5.8	
General government deficit	-4.4	-9.0	-9.9	-8.8	-8.1	-7.7	
General government debt 4/	74.6	75.4	71.3	66.7	66.2	65.7	
Money and credit (y/y percent change, end-period) 5/							
Broad money	21.4	19.3	16.8	16.0	16.0	18.2	
Credit to commercial sector	21.1	16.9	15.8	21.3	18.8	...	
Financial indicators (percent, end-period) 6/							
91-day treasury bill yield	7.2	5.0	4.4	7.3	8.6	...	
10-year government bond yield	7.6	7.0	7.8	8.0	8.4	...	
Stock market (y/y percent change, end-period)	19.7	-37.9	80.5	10.9	...	...	
External trade 7/							
Merchandise exports (US\$ billions)	166.2	189.0	182.4	250.5	274.2	307.4	
y/y percent change	28.9	13.7	-3.5	37.3	9.5	12.1	
Merchandise imports (US\$ billions)	257.6	308.5	300.6	381.1	428.2	489.1	
y/y percent change	35.1	19.8	-2.6	26.7	12.4	14.2	
Balance of payments (US\$ billions)							
Current account balance	-15.7	-27.9	-38.2	-45.9	-47.6	-56.3	
(in percent of GDP)	-1.3	-2.3	-2.8	-2.7	-2.8	-3.0	
Foreign direct investment, net	15.9	22.4	18.0	9.4	18.8	22.3	
Portfolio investment, net (equity and debt)	27.4	-14.0	32.4	30.3	11.1	24.1	
Overall balance	92.1	-20.1	13.4	13.1	5.5	17.1	
External indicators							
Gross reserves (in billions of U.S. dollars, end-period)	309.7	252.0	279.1	304.8	298.6	315.7	
(In months of imports) 8/ 9/	10.3	8.4	7.2	6.8	5.7	5.5	
External debt (in billions of U.S. dollars, end-period) 8/	224.4	224.5	261.0	298.4	337.4	384.7	
External debt (percent of GDP, end-period)	18.1	18.4	19.2	17.7	19.7	20.7	
Of which: short-term debt 9/	6.8	6.7	6.7	6.9	8.0	8.7	
Ratio of gross reserves to short-term debt (end-period) 9/	3.7	3.1	3.1	2.5	2.2	2.0	
Debt service ratio 10/	5.3	5.1	4.9	4.7	5.6	5.8	
Real effective exchange rate							
(y/y percent change, period average for annual data)	8.7	-6.8	8.0	11.6	...	...	
Exchange rate (rupee/US\$, end-period) 6/	40.3	51.2	45.5	45.0	...	...	

Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; Bloomberg L.P.; 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 2011/12, as of October 2011.

6/ For 2011/12, as of October 2011.

7/ On balance of payments basis.

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

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

10/ In percent of current account receipts excluding grants.



**Statement by Arvind Virmani, Executive Director for India  
and Michael Patra, Senior Advisor  
March 9, 2012**

1. We welcome staff's candid assessment of recent macroeconomic and financial developments in India and the evolving outlook, based as it has been on constructive and open-minded engagement by our authorities during 2011 and early 2012. This year's Article IV consultation assumes added importance in view of the high uncertainty characterizing the global environment, which is impacting India's macroeconomic performance and prospects on a persisting basis. This consultation is also noteworthy for it being co-terminus with the Financial Sector Assessment Program. While there is broad consistency between staff's analysis and the assessment of our authorities in several aspects, there are also some areas of divergence which we address in this statement.

**Recent Macroeconomic Developments**

2. It is heartening to note staff's impatience with the under-actualization of India's growth potential - in ascribing the recent slowdown to 'governance scandals' and 'civil activism', aspects in the life and ethos of every open, secular and pluralistic democracy the world over, as currently being witnessed, but inevitably subservient to the rule of law, as demonstrated in India. To draw casual connections between these events and the slowing of the economy is speculative and runs the risk of missing more fundamental factors at work. It is necessary to recognise that the slowdown is common to all major economies that experienced a robust rebound from the crisis of 2008-09; however, a careful analysis of high frequency data may indicate that the Indian economy has been undergoing a cyclical moderation that set in during the second half of 2010-11 (April-March), again a phenomenon recorded across the world. Lead indicators – capacity utilisation; new investment intentions; sales growth; order books; business confidence – are all exhibiting cyclical effects.

3. Additionally, two factors have accentuated the downturn. First, the worsening external environment is strongly impacting demand – as staff has correctly noted, India's investment, which is the main driver of the current downturn, has become closely correlated with the global cycle (page 23). In particular, corporate investment in manufacturing and tradeables shows close co-movement with global demand. Our estimates show that a one percentage point decline in global growth could result in 0.3 percentage points decline in the growth of non-agricultural domestic demand. Furthermore, one percentage point decline in India's gross fixed capital formation could shave off about 0.2 percentage points from potential output growth.

4. Secondly, the anti-inflationary monetary policy stance has had a dampening effect on investment demand as well as on interest-sensitive components of private consumption, as was expected in view of the objective of lowering inflation. The Reserve Bank of India (RBI) has raised its policy rates on 13 occasions since March 2010 amounting to an increase of 350 basis points – the most aggressive central bank response to inflation in recent times. Inflation has moderated significantly since January 2012.

5. Lead indicators are now suggesting that the economy is reaching the bottom of the cycle. In January 2012, purchasing managers indices for India reached their highest level since April 2011, led by forward-looking indicators of output and new orders. The PMIs have continued to remain in expansionary mode in February 2012, *albeit* with a slight moderation in output growth. The February 2012 OECD composite leading indicator for India points to an upward positive change in momentum. While private consumption has been resilient, a durable easing trend in core inflation will boost consumer confidence significantly. Exports have expanded by 26 percent in the financial year up to December 2011, outpaced by import growth. As capital flows turned volatile, there was a drawdown of reserves to finance the rising current account deficit. In retrospect, it was the arsenal of policy instruments available and the measured approach to capital account management that restored stability and enabled a modest real appreciation in the early months of 2012. Our authorities are fully cognisant that a large and/or prolonged external shock could easily overwhelm these efforts and cloud the outlook.

### **The Quality of Growth**

6. In evaluating the performance of the Indian economy and the road ahead, it is perhaps useful to step back and take a longer-term perspective. Over the period 2007-12 (April-March), average GDP growth of around 8.2 per cent, as against 7.8 percent in the preceding five-year period, was achieved in a difficult international environment. This implies a 35 per cent increase in per capita GDP during 2007-12. The progress towards inclusiveness is difficult to assess, because inclusiveness is a multidimensional concept. Yet some progress has been achieved. Illustratively, preliminary estimates suggest that poverty declined by approximately one percentage point per annum during the five-year period 2004-05 to 2009-10, faster than before. India is well poised to meet the Millennium Development Goal target of 50 per cent reduction of poverty between 1990 and 2015. The National Rural Employment Guarantee Act (MGNREGA), with a people-centered, demand-driven architecture, has directly led to the creation of 9.9 billion person-days of work since its inception in 2006-07. In 2010-11 alone, the MGNREGA generated employment to the tune of 2.53 billion person-days. It has also successfully raised the bargaining power of agricultural labour resulting in higher agricultural wages, reduction in distress migration and has also secured some inclusivity in the growth process. The progress achieved so far may be modest relative to aspirations, but an important consequence of the intensified focus on inclusion has been heightened awareness and empowerment, greater desire to access information about rights and entitlements, and eagerness to demand accountability from the public delivery systems.

### **Outlook**

7. Over the next five years (2012-17), our authorities are putting in place a growth strategy that envisages a return to our estimate of potential output growth of 8.5 to 9 percent. In this regard, we differ from staff's estimates of potential growth which seem to vary annually and are sensitive to choice of methodology, in contrast to our view that potential growth is a medium- to longer-term concept that reflects underlying structural trends rather than cyclical variations and year-to-year shifts and events. What shall be the drivers of this return to trajectory? First, the high rates of investment and private sector savings constitute strong macro-economic fundamentals supporting high growth. Secondly, with India's young population, the labour force is expected to increase by 32 per cent over the next 20 years and

add to the growth potential. Thirdly, the thrust on accelerating the pace of investment in the physical infrastructure will be sustained. Since more than two-thirds of the investment in the economy is by the private sector, public-private partnership-(PPP)-based efforts, already one of the largest in the world, are expected to constitute 50 per cent of the estimated investment in infrastructure of about 10.0 per cent of GDP by 2016-17, up from 30.0 per cent currently. Measures are being taken to enhance private sector funding of infrastructure. The establishment of infrastructure debt funds is a step in this direction. The creation of a vibrant and liquid corporate bond market is being taken up on a priority basis. Fourthly, Indian companies in many sectors have shown capacity for innovation, which needs to be nurtured and strengthened through a greatly expanded programme of Research & Development (R&D). Fifthly, constraints arising from the supply side, such as better availability of water, power and land-based resources will be the focus of the growth strategy for the medium-term.

### **Monetary Policy Issues**

8. An issue that has vexed our authorities is staff persisting in stating that “the RBI could give more weight to the CPI in policy formulation over WPI” (paragraph 16) repetitively in successive Article IV Consultation reports. As a comprehensive CPI did not exist till January 2011 this appears disingenuous. CPIs continue to be dominated by food items, and the efficacy of monetary policy to deal with food inflation is limited. Accordingly, in the Indian context, the conduct and formulation of monetary policy cannot be guided solely by CPI movements. The RBI therefore follows a multiple indicator approach to the monitoring of inflation, closely monitoring and analyzing movements in the three available sectional CPIs (CPI for industrial workers; CPI for agricultural labourers; CPI for rural labourers). The RBI communicates its forecasts in terms of the WPI simply because the CPIs relate to specific sections of the population whereas the WPI is a national-level index (and the RBI is a national - not sectoral- or section-level- institution). This is not a phenomenon peculiar to India. Illustratively, in the USA, inflation is measured by the CPI, but the Federal Reserve prefers to communicate its view of inflation in terms of the personal consumption expenditure deflator. This by no means implies that more weight or less weight is given to one indicator over another in the analysis of inflation. Now that a new comprehensive CPI has been developed, it is bound to play a greater role once it has an established track record. Given the wide diversity of the Indian population and variations in consumption baskets, it has been found necessary to compile CPIs for the rural and urban population to measure inflation. The latter indices are being compiled since January 2011, and so far only twelve observations are available. The fact that national-level CPIs are being compiled is indicative of the intention of our authorities, but they would wait for enough observations to be convinced that the new CPIs have stabilized, that they truly reflect inflation conditions and that they are well understood by the public.

### **Fiscal Policy**

9. With tax revenues affected by the cyclical downturn in growth, and expenditures overshooting mainly on account of the impact of the significantly higher than budgeted global prices of crude and fertilizer, restraining the fiscal deficit in 2011-12 to the targeted path of consolidation is proving to be a major challenge. The final outcome will be known on March 16, 2012 when the Union Budget for 2012-13 will be presented to the Parliament.

Accordingly, it is premature to speculate on the actual outcome at this juncture (as in paragraph 9 of the staff report). The trajectory of deficit adjustment continues to be downward; in terms of averages for the years 2010-11 and 2011-12 rather than for each year in isolation, fiscal consolidation remains on track. The public debt/GDP ratio at 67 percent at the end of 2010-11, according to the September 2011 WEO, is already very close to the target of 68 percent set for 2014-15.

### **Financial Sector Issues**

10. Our authorities welcome the comprehensive review of India's financial sector and the quality of regulation and supervision in India under the FSAP. They regard this engagement as extensive and productive. Although there are some differences of views, they fully recognize the importance of the FSAP in contributing to financial stability in India and express strong support for the role FSAP plays in promoting the soundness of the global financial system. India remains committed to phased adoption of international standards and best practices calibrated to suit our local conditions to meet the developmental and inclusion goals as well as to maintain stability in the financial system.

11. We will restrict our comments to our key concerns relating to some of the findings/recommendations in the FSSA. First, while the level of non-performing assets at 2.8 percent of total assets in the banking system has shown a modest increase in 2011, it compares favourably with asset impairment levels in both major advanced economies and peer economies. Secondly, with regard to the issue of large exposure limits, this is driven by the development needs of the country, especially in the context of the need to finance investment in infrastructure. Tightening the concentration limits would severely constrain the availability of bank finance, which is the major source of finance for this purpose. Thirdly, while the FSAP report recognizes the benefit of the cash reserve ratio (CRR)/statutory liquidity ratio (SLR) in providing liquidity to banks in crisis time, it neglects the financial stability enhancing role played by them – the large pool of liquid assets comprising the highest quality collateral which helped Indian banks to deal with the tightening of liquidity during the global financial crisis of 2008-09, and which places them in an advantageous position with respect to compliance with Basel III norms. Furthermore, staff's argument that mandatory holdings weaken monetary transmission is not clear as government market borrowings are at market-determined interest rates and monetary policy actions impact such yields. Moreover, banks voluntarily hold higher than mandated levels of these securities. Fourthly, several steps have been taken to improve oversight over interconnectedness and financial conglomerates including (i) prudential limits on aggregate interbank liabilities; (ii) restricting uncollateralised funding to banks and primary dealers with caps on both lending and borrowing by these entities; (iii) restrictions on capital instruments of banks; (iv) restrictions on banks' exposure to non-bank financial companies (NBFCs), and tighter regulation of NBFCs; and (v) intensive monitoring of financial conglomerates and common exposures in sensitive sectors. Our authorities also fully recognize the importance of establishing information sharing arrangements with other jurisdictions and are expanding appropriate information sharing networks on a priority basis. There are substantial developments in the areas of home-host relationships as well as engagement with supervisors in other jurisdictions on an ongoing basis.

**Conclusion**

12. The macroeconomic fundamentals of the Indian economy are strong and resilient. Over the past two years, the challenges of inflation and fiscal consolidation have necessitated a focus on demand management. It is now time to address supply side issues. The productivity and innovation enhancing elements in the New Manufacturing Policy and the National Skill Development Mission, along with intensified efforts to bridge the gaps in physical and social infrastructure, are intended to release the supply constraints and allow India to renew its tryst with *faster, sustainable and more inclusive growth*, the theme of our approach to the Twelfth Five Year Plan covering the period 2012-17.