

**FOR
AGENDA**

SM/09/22
Correction 2

February 5, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **India—Staff Report for the 2008 Article IV Consultation**

The attached correctionsto SM/09/22 (1/23/09) have been provided by the staff:

Mischaracterizations of the Views of the Authorities

Page 16, para. 17, lines 9-10: for “They expected 2008/09 growth to be in the range of 7-8 percent.” read “They expected 2008/09 growth at 7 percent.”

Page 18, para. 20, line 13: for “because the RBI intervened aggressively to support the rupee, liquidity pressures” read “because the RBI intervened aggressively, liquidity pressures”

Page 22, para. 27, lines 1-2: remove “The RBI did not see the need for additional interest rate or liquidity measures at the time of the mission.”; **line 2:** for “The steps they had already taken” read “The RBI stated that the steps they had already taken”

Page 31, para. 40, lines 11-13: remove “Finally, the authorities did not see any need to adopt contingency plans as they considered it highly unlikely that there could be systemic problems.”

Page 37, para. 57, lines 3-4: remove “since plan spending in the first two years of the 11th Five Year Plan (2007–12) was relatively modest,”

Factual Errors Not Affecting the Presentation of Staff’s Analysis or Views

Page 8, para. 6, line 7: for “(13 percent since end-August)”
read “(11 percent since end-August)”

Page 12, para. 10, line 9: for “and off-budget bonds” read “and subsidy-related bonds”

Page 12, para. 10, last line: add footnote 4 “These subsidy-related bonds are not included in the authorities’ definition of the central government budget deficit, while they are included in the staff’s definition.”

Page 13, para. 13, lines 8-9: remove “Hence, overall capital flows are projected to be negative even in 2009, although less so than in 2008.”

Page 14, box 2, third bullet, line 1: for “Credit quality is likely to deteriorate” read “Credit quality could deteriorate”; **line 3:** remove “aggressively”

Page 24, box 4, second para., line 3: for “14 percent” read “12½ percent”; **line 4:** for “at 8 percent.” read “close to 9 percent.”; **line 4:** add footnote 1 “These data refer to September 2008.”; **line 5:** for “70 percent” read “74 percent”.

Page 24: box 4, first bullet, line 10: for “In such a scenario” read “In such an extreme scenario”

Page 25, box 4, first para., line 4: for “15 percent” read “19 percent”

Page 25, box 4, fifth bullet, line 1: for “10 percent” read “7 percent”

Page 28, first para., line 6: for “10 percent cap on foreign investors’ voting rights” read “10 percent cap on single investors’ voting rights”

Page 33, para. 46, line 3: for “corporate bankruptcies” read “corporate distress”

Page 34, para. 48, line 12: for “off-budget spending.” read “subsidy-related bonds.”

Page 42, figure 4, footnote 1: for “off-budget bond” read “subsidy-related bond”

Page 44, table 2, row 9, column 4: for “44.8” read “36.0”
row 10, column 4: for “46.2” read “37.5”

Page 44, table 2, last row and footnote 5: for “Off-budget related bond” read “Subsidy-related bond”

Page 47, table 5, line 55: for “Off-budget bonds” read “Subsidy-related bonds”;
footnotes 4 and 8: for “off-budget subsidy-related bond” read “subsidy-related bond”

Page 48, table 6, row 18, heading: for “(augmented with off-budget bonds)” read “(augmented with subsidy-related bonds)”

Page 49, table 7, row 10, column 4: for “44.8” read “36.0”
row 11, column 4: for “46.2” read “37.5”

Page 49, table 7, last row: for “Off-budget subsidy-related bond issuance”
read “Subsidy-related bond issuance”

Page 49, table 7, footnotes 4 and 5: for “off-budget bond issuance”
read “subsidy-related bond issuance”

Page 50, Table 8, Row 16:

for Other investment (loans, trade credits, etc.)	1.4	3.4	5.7	1.6
read Other investment (loans, trade credits, etc.)	1.4	1.3	3.1	3.6

Page 50, Table 8, Sources: for “Data provided by the Indian authorities; and Fund, *Information Notice System* and staff estimates and projections.” read “Data provided by the Indian authorities; CEIC Data Company Ltd.; Bloomberg L.P.; and Fund, *Information Notice System* and staff estimates and projections.”

Page 51, table 9: replaced

Page 53, para. 6, line 6: for “off-budget bond” read “subsidy-related bond”

Page 55, table 1, last row and footnote 5: for “Off-budget subsidy-related bond”
read “Subsidy-related bond”

Typographical Error

Page 30, first para., line 1: for “fore example” read “for example”

Questions may be referred to Ms. Papi (ext. 36894), Ms. Richter Hume (ext. 34978), and Ms. Oura (ext. 38166) in APD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (24)

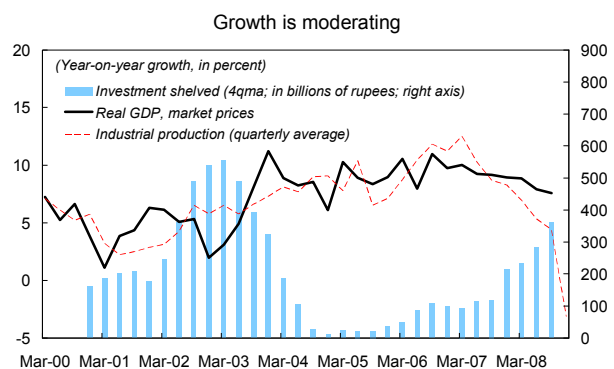
Other Distribution:
Department Heads

II. CONTEXT: FIRST INTERNATIONAL FINANCIAL CRISIS SINCE INDIA WENT GLOBAL

1. **India faces the first global economic crisis since emerging as an economic powerhouse.** Reaping the benefits of reforms, macroeconomic stability, and a supportive external environment, India achieved growth of $8\frac{3}{4}$ percent on average during 2003/04-2007/08, with a significant reduction in poverty.¹ The surge in investment, the key driver of growth, was financed by rising private and public savings, but increasingly also by foreign capital as links with the rest of the world grew (Figure 1). Now the global crisis is hitting India's financial markets and is sharply curtailing external funding, jeopardizing investment and growth.
2. **The consultation focused on the implications of the global crisis for India and the needed policy response.** While the response needs inevitably to be focused on dealing with short-term pressures, these should be set in the context of the longer-term challenges and reforms that India needs to support strong and inclusive growth. In particular, given the country's massive investment needs, it is essential that scarce fiscal resources be focused on jumpstarting infrastructure investment, together with further opening up to foreign inflows and developing the domestic corporate bond market to augment the needed financing. At the same time, reforms to reduce subsidies and other unproductive expenditure will go a long way to provide assurances of the government's commitment to fiscal consolidation.

III. RECENT DEVELOPMENTS: GLOBAL HEADWINDS EXACERBATE DOMESTIC WEAKNESSES

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

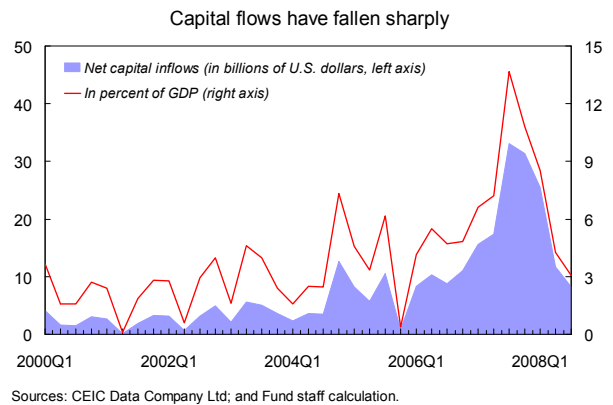
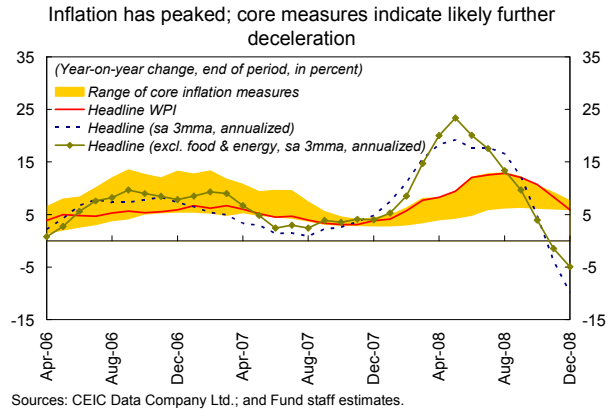


4. **Inflation is decelerating rapidly after rising markedly in mid-2008.** Headline inflation (WPI) surged to almost 13 percent (y/y) in August 2008, but dropped to below 6 percent by December. Commodity prices were the drivers of the initial inflation spike, with

¹ The fiscal year starts in April.

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

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



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

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

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

Measures to encourage capital inflows

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

Fiscal measures

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

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

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

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

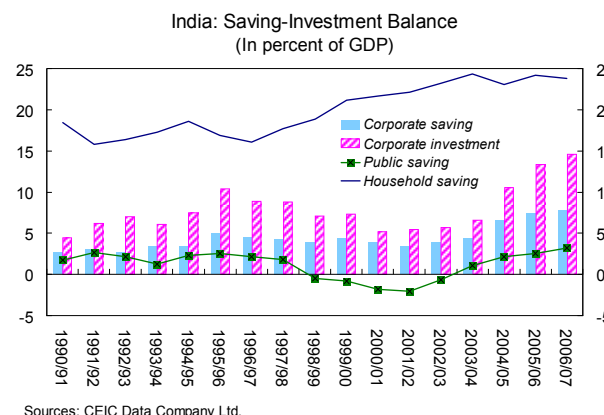
IV. OUTLOOK: A MARKED SLOWDOWN WITH HIGH UNCERTAINTY AND DOWNSIDE RISKS

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

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

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

envisaged slowdown is sharper than that at the time of the 2001 global recession when nonagricultural growth slowed from 7.8 percent in 1999/2000 to 5.9 percent in 2000/01. The current global crisis far exceeds the extent of past recessions and India is significantly more integrated with the rest of the world. As in 2001, investment is likely to weaken substantially via the financing and confidence channels combined with softer demand (Box 2). Moreover, declining corporate profitability and savings will likely reverse the past years' upward trend in domestic savings that enabled investment-led growth to take off.



Stimulus measures and a good harvest should support consumption somewhat, but the growth impact of the recently approved fiscal measures could be limited by implementation capacity constraints and only partial pass through of tax reductions to prices. Export growth is projected to fall, but weaker domestic demand should also reduce import growth, keeping net exports' contribution to growth broadly stable.

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

13. **The overall balance of payments is projected to be in deficit this year and next.** The current account deficit is projected at below 3 percent of GDP in 2008/09, before narrowing to 1½ percent of GDP next fiscal year due to lower oil prices and softer domestic demand, and as the rupee depreciation buffers the effect of slowing external demand on exports. Although it is difficult to predict when investor risk appetite will return, portfolio and debt capital flows are unlikely to recover appreciably at least until late 2009.⁶ FDI flows, beyond projects already in the pipeline, are also expected to slow and are unlikely to pick up before the recovery in advanced economies materializes.⁷

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

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

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

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

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

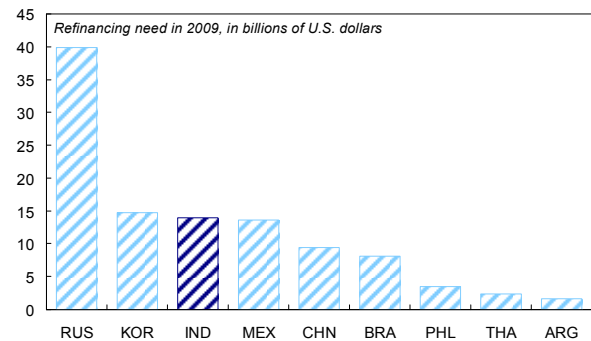
- Lower investment and growth resulting from reduced availability of financing, higher funding costs, and deteriorating sentiment.** By 2007/08, the share of Indian corporates' funding from external sources had risen to 25 percent, while equity issuance accounted for an additional 10 percent. Corporate profitability is expected to deteriorate considerably, thus reducing firms' internal sources of funding. Weaker demand and uncertainty about the outlook are also depressing investment.
- Some firms and sectors could face dollar funding problems.** India's private sector is exposed to a deterioration in investor sentiment mainly in the equity market, where foreigners hold about US\$53 billion in shares, a third of the free float. In addition, some large Indian firms are facing significant near-term FX refinancing pressures. The amount of foreign borrowing (bonds and loans) by Indian banks and corporates falling due in 2009 is the third largest among emerging markets. Moreover, the net asset position of Indian banks and corporates vis-à-vis BIS reporting banks has deteriorated rapidly over the last two years, and has become negative. The availability of trade credits was also sharply reduced in the fall of 2008 in line with global developments.
- Credit quality could deteriorate substantially, which could lead financial institutions to cut credit.** India's credit expansion has been fairly strong compared to other emerging markets. Maturation of the domestic credit cycle and an expected deterioration of corporates' financial situation (especially SMEs and real estate firms) are expected to affect banks' performance adversely.
- A weaker rupee.** FX debt is estimated to amount to 20–30 percent of total corporate debt. Continued depreciation would especially affect those firms that have borrowed in FX without hedging, with banks in turn exposed to the deterioration in the financial health of their borrowers. It could also entail higher cost of finance externally and domestically. A depreciation would also increase the current account deficit in the short run.

The contribution from foreign financing has risen significantly

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

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

India's refinancing needs are high among EMs



Source: J.P. Morgan.

India's international investment position has turned negative 1/

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

Source: Reserve Bank of India.

1/ As of June 2008.

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

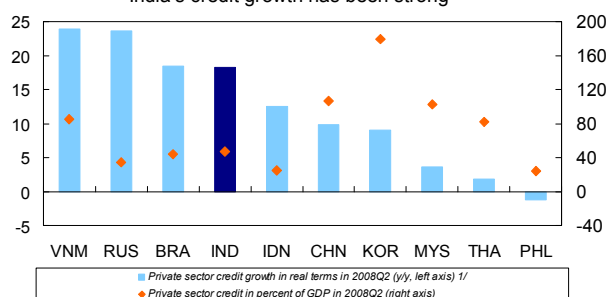
Despite these spillovers and vulnerabilities, there are risk-mitigating factors.

- **Low levels of external debt and strong reserve coverage.** India's gross external financing requirement and total external debt are low¹ and more than covered by reserves (50 and 75 percent of reserves, respectively). Although it has increased recently, the leverage of nonfinancial firms is in line with regional peers.

- **Limited spillovers through trade.**

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

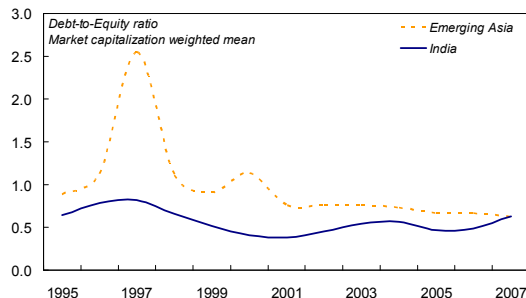
India's credit growth has been strong



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

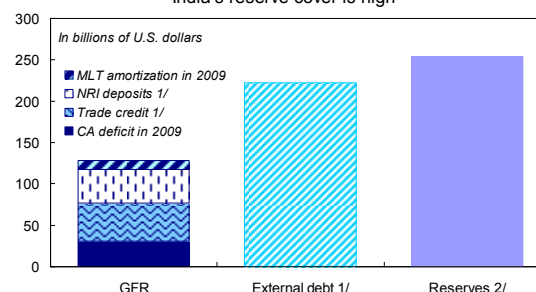
1/ Data for the Philippines pertain to end-2007. Except for China nominal credit to the private sector is deflated by the quarterly GDP deflator. For China, the consumer price index is used.

India's corporate leverage is in line with regional peers



Source: Fund, Corporate Vulnerability Utility.

India's reserve cover is high



Source: Country authorities, and Fund staff estimates.

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

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

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

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

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

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

Authorities' Views

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

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

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

V. POLICY DISCUSSIONS

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

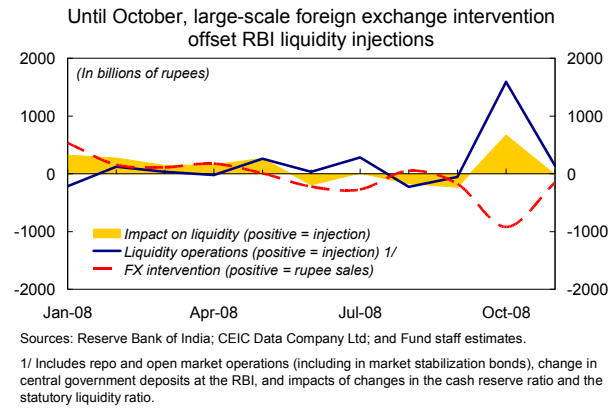
Authorities' Views

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

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

Background

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



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

Nonbank financing for industry has fallen sharply

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

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

Box 3: Select Cross-Country Comparisons of Financial Measures

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

Domestic Liquidity Provision

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

FX Liquidity Provision

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

Facilities to Supplement International Reserves

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

Credit Guarantees

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

Bank Recapitalization

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

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

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

Authorities' Views and Plans

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

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

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

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

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

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

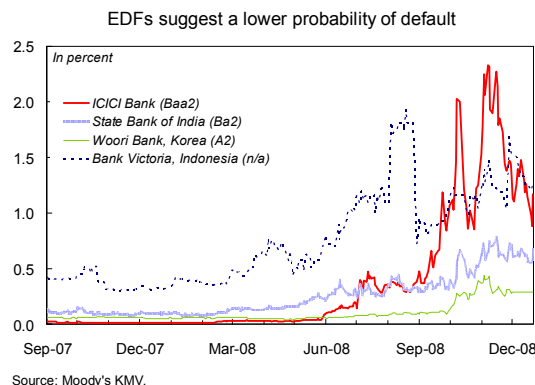
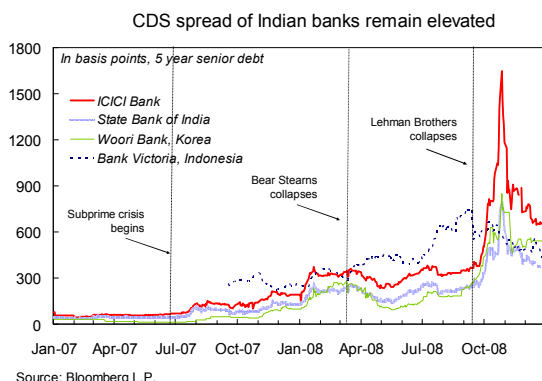
B. Keeping Credit Flowing While Maintaining Financial Stability: The Role of Financial Sector Policy

Context

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

Box 4. India: Financial Stability Risks

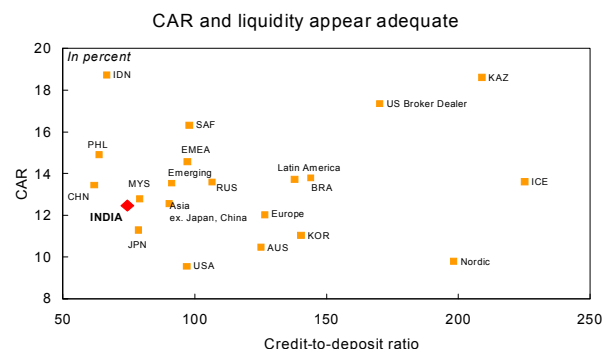
Financial stability risks in India have risen in line with global developments. CDS spreads for Indian banks jumped sharply in mid-September and although they have eased since November, they remain elevated and are comparable to those of Indonesian and Korean banks, which are perceived to be vulnerable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



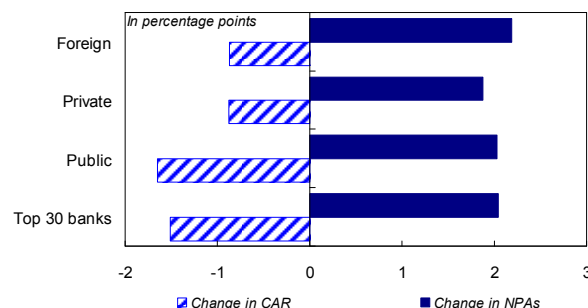
Indian banks compare favorably internationally in terms of capitalization and wholesale funding risks. Their average capital adequacy ratio (CAR) is 12½ percent, with tier 1 capital close to 9 percent.¹ Their credit-to-deposits (CD) ratio at 74 percent is relatively low, particularly compared to those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

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

- Credit risk.** Staff's stress tests indicate that the capitalization of systemically important banks does not drop below the regulatory CAR minimum (9 percent) if impaired loans rise to twice the current gross NPA ratio of 2½ percent. This provides some comfort. However, spillovers from the global financial crisis coinciding with the turning of the domestic credit cycle could result in a substantial increase in NPAs. For example, some countries during the Asian crisis saw NPAs increase as much as 200-300 percent. In such an extreme scenario, the capital position of a number of Indian systemically important banks would fall below the minimum CAR. In addition, while banks' interest rate risk is relatively low as most loans (including mortgages)



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



Sources: Bankscope; and Fund staff estimates.

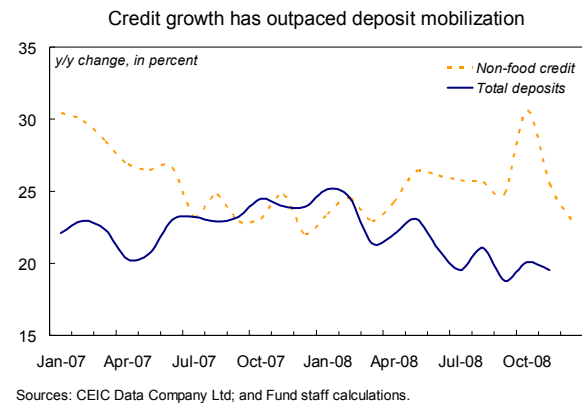
1/ Based on staff's stress test estimates of top thirty banks by asset size as of March 2008.

¹ These data refer to September 2008.

Box 4. India: Financial Stability Risks, Concluded

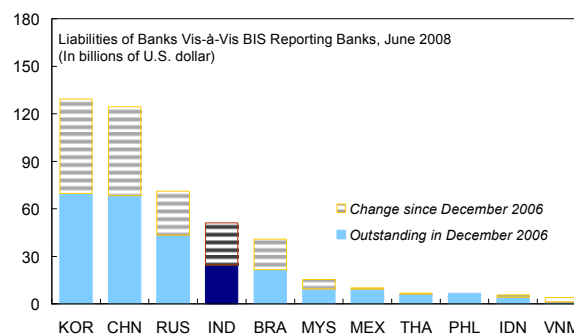
are at floating rates, indirect credit risks related to an interest rate spike could be significant. In terms of sectoral exposure, industry accounts for about 40 percent of total bank credit (of which roughly a quarter is to small firms). The property sector, which has come under considerable stress with real estate prices already down sharply and likely to fall further, accounts for about 19 percent of bank credit (with the majority accounted for by housing loans), although this does not include the indirect exposure via nonbank financing institutions and collateral.

- Liquidity risk.** Even before the onset of the recent crisis, Indian banks had seen much more rapid credit than deposit growth. This had been accompanied by a sharp rise in external liabilities to BIS reporting banks (with liabilities at US\$51 billion at end-June 2008 or about 5 percent of total assets, double their end-2006 level) financing a growing share of foreign currency loans to residents (from 16.2 percent of total foreign assets in March 2001 to 47.8 percent in December 2007), suggesting a potential maturity mismatch in their FX book. The largest share of external liabilities is accounted for by nonresident deposits (27 percent), a relatively stable source of finance, although in the past they have declined at times of stress. Starting in September, the withdrawal of foreign credit lines to banks in India and Indian bank branches abroad increased dollar funding risks. While banks responded by borrowing in the domestic interbank market, the spike in interest rates demonstrated the link between domestic and global liquidity.
- Exposure to structured credit products, troubled financial institutions, and derivatives.** According to the RBI, India has no exposure to U.S. subprime mortgage assets and ICICI is the only bank with a non-negligible exposure to other structured credit products. The total exposure to five troubled global institutions is reported at US\$1 billion (0.1 percent of system's assets). While these exposures are small compared to earnings and capital, they are fairly concentrated. As in Korea, Indian banks also face an earnings shock from FX derivatives losses (the authorities estimate mark-to-market losses at \$5.5 billion).
- Foreign exchange risk.** Stringent daily limits on net foreign exchange open position limits and restrictions on foreign borrowing by banks are deemed to have limited their exposure to FX risks. Nevertheless, it is not clear to what extent banks may be affected indirectly by corporations' unhedged FX exposures and/or FX derivative losses. Also, within their FX book, banks may have maturity mismatches, which have not been publicly disclosed.
- Equity risk:** banks' overall exposure to equity is limited to less than 40 percent of net worth and if loans are secured against shares, the margin has to be 50 percent: nevertheless, the latter may be insufficient in some cases when equity volatility is as high as in recent months.
- ICICI,** which accounts for about 7 percent of the banking system and was the poster child of innovation and India's global ambitions having pursued a more aggressive business model, has come under significant pressure. Its stock price has fallen 46 percent since end-August and bond yields have spiked to 12-17 percent. According to the RBI, its exposure to global structured credit products is \$1.5 billion (about 1.5 percent of assets and 10 percent of capital). It also has wholesale funding vulnerabilities in the off-shore market, with wholesale borrowing accounting for 57 percent of its overseas book. ICICI's contingent liabilities (notional amount) of FX, interest rate, and credit derivatives are large compared to its assets/ equity, creating uncertainty regarding true risks.
- There are also several information gaps (e.g. off-balance sheet derivative positions, and foreign borrowing mismatches and covenants) that make a conclusive assessment of financial stability risks difficult.** These gaps call for further data dissemination, analysis of asset quality, and stress testing of banks allowing for extreme events, multiple factors and feedback loops from the corporate sector.



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

Indian banks had recently increased funding from foreign sources



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

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

Policy Response

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

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

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

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

- **Avoiding masking the underlying capital position of financial institutions.** Recent reductions in provisioning requirements are consistent with countercyclical prudential regulation and cuts in risk weights can also be viewed in this light, particularly since they still meet the minimum Basel standards. However, measures that permit regulatory forbearance on asset classification—for example, allowing restructured assets not to be classified as NPAs—obscure banks’ true asset quality and undermine confidence in the accuracy of their accounts in the absence of disclosure. These measures could defer the recognition of bad assets, encourage adverse selection of borrowers, and undermine risk management practices.
- **Providing incentives for early loss recognition.** Banks could be given the right to absorb the losses arising from the difference between the book and new net present value of restructured assets in a special account limited in size (say up to 1 percent of risk-weighted assets), not immediately set off against regulatory capital. The accounting losses in this account could be amortized over time or through capital raised when markets become vibrant again. Also, consideration could be given to making public money available to banks for recapitalization conditional on certain restructuring targets.
- **Identifying capital needs and recapitalizing banks.** The RBI should move quickly to estimate the likely increase in NPAs, and hence the possible need for additional capital. The authorities have announced their intention to raise the capital of some public banks to 12 percent of risk weighted assets, and have pledged spending of 0.4 percent of GDP for this purpose. This proposed increase in capital should be

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

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

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

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

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

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

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

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

- **Further capital account liberalization.** The authorities have already taken numerous measures, some since the conclusion of the mission (see Box 1).²¹ To sustain access of Indian borrowers to foreign capital and ensure smooth refinancing of external debt, all interest rate caps and minimum maturity requirements on foreign borrowing, including trade credits, should be lifted. To position India well for when the tide of capital flows turns, the authorities should (i) liberalize FDI, especially in the financial sector; (ii) ease restrictions on foreign borrowing and foreign participation in local debt securities markets;²² and (iii) expand the range of contracts and participants in the derivatives markets. Consideration could be given to tapping multilateral development banks' trade credits. Rediscount facilities for trade credits could be expanded and foreign exchange auctions for this specific purpose (as part of the foreign exchange swaps proposed above or separately as outright sales) could be carried out.
- **Improving banking system efficiency and reach.** When credit is less readily available, the premium on its efficient allocation becomes greater. Efficiency could be improved by (i) lowering the minimum government ownership in public banks and increasing managerial autonomy; (ii) liberalizing interest rates on priority-sector loans and introducing priority-sector loan certificates; (iii) allowing greater foreign investment in banks; and (iv) allowing more consolidation in the banking sector, including by domestically incorporated subsidiaries of foreign banks.

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

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

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

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

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

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

Authorities' Views

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

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

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

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

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

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

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

Finally, the deposit insurance coverage was judged to be adequate covering 93 percent of the total number of accounts as against international benchmarks of 80 percent.

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

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

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

C. India's Corporate Sector: A Challenging Outlook

Background

44. **While corporate balance sheets appeared healthy through early 2008, the recent sharp deterioration in financial and economic conditions is likely to have heightened vulnerabilities.** Staff's analysis suggested that such a deterioration is likely to have more

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

than doubled the share of companies facing difficulties in servicing their debt (defined as firms with earnings below interest expenses).²⁷ Moreover, the exceptional equity volatility and the steep fall in equity prices have increased the probability of distress.

Policy Response

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

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

Authorities' Views

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

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

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

D. Fiscal Policy: Limited Room for Further Stimulus

Background

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

Near-Term Policy Response

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

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

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

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

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

3/ For details, see Box 1.

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

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

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

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

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

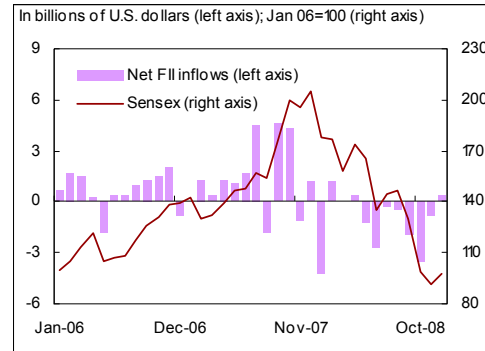
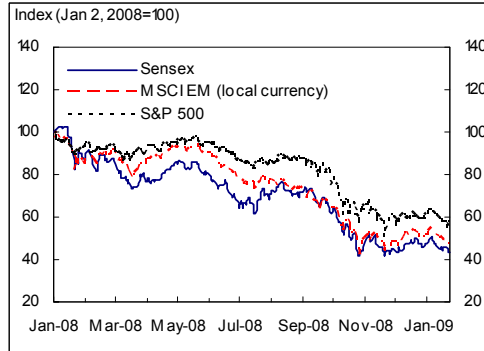
59. **The authorities viewed the FRBMA as having been very useful in instilling fiscal discipline.** They pointed to its role in sensitizing ministries and departments and acting as a catalyst for fiscal consolidation at the state level. However, as the Thirteenth Finance

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

Figure 3. India: Impact of the Global Financial Crisis

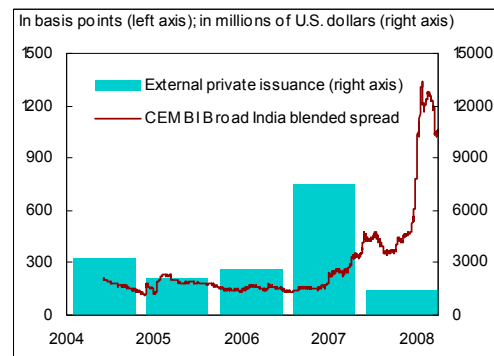
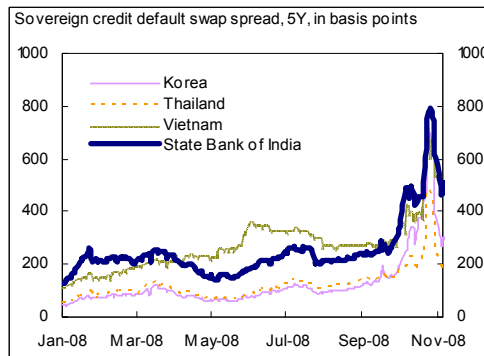
Taking the cue from global markets, equity markets in India have declined...

...driven by heavy portfolio outflows.



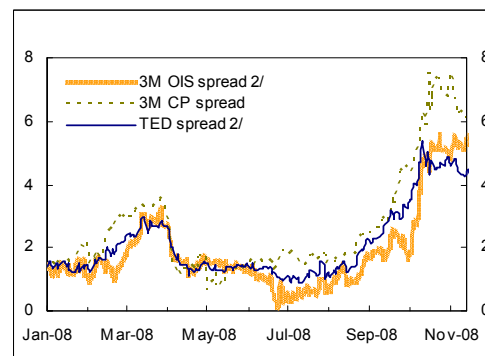
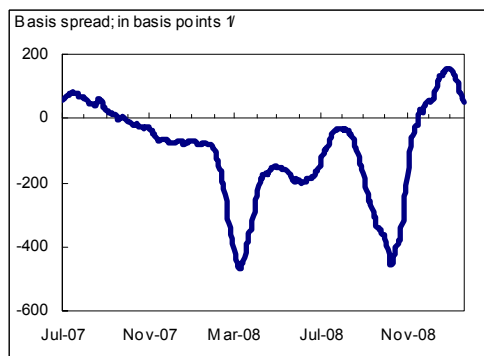
Credit conditions have tightened in line with rising global risk aversion...

...resulting in lower appetite for Indian bonds.



Dollar funding has been under pressure...

...and domestic liquidity conditions are tight.



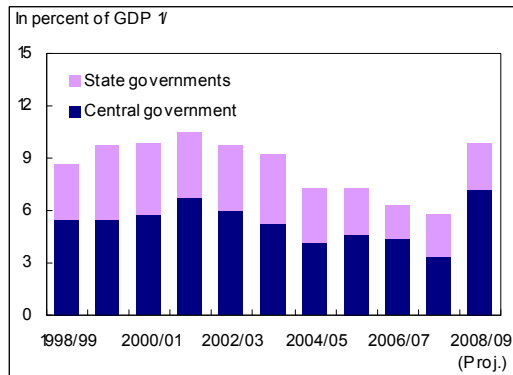
Sources: Reserve Bank of India; Bloomberg L.P.; Dealogic; and Fund staff calculations.

1/ Priced from 3-month currency forwards and computed from 20-day moving average.

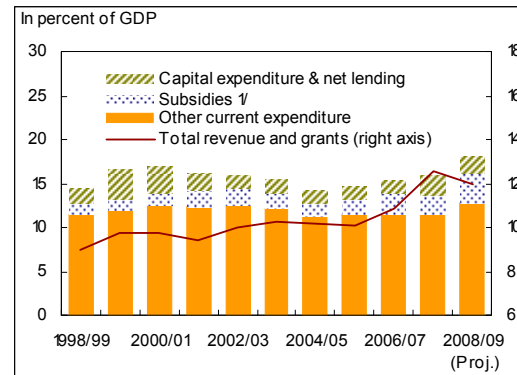
2/ Difference from 3-month National Stock Exchange Mumbai Interbank Offer Rate (MIBOR).

Figure 4. India: Fiscal Indicators

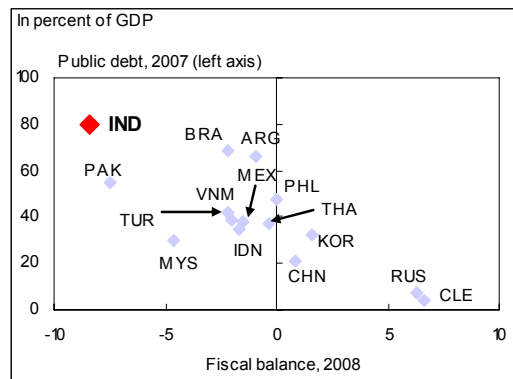
The trend of fiscal consolidation will be reversed in FY 2008/09...



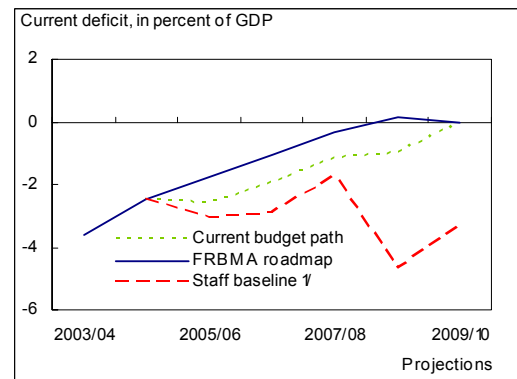
...as fiscal measures and a soaring subsidy bill weigh on government finances.



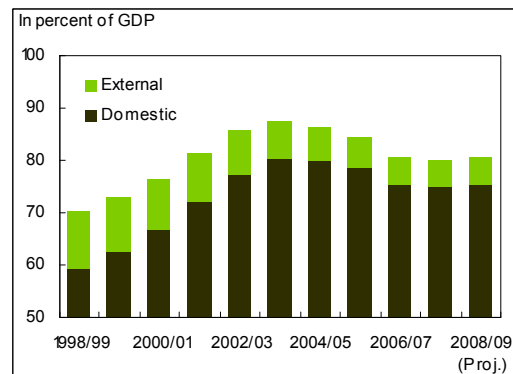
India's fiscal position is one of the weakest among the emerging economies.



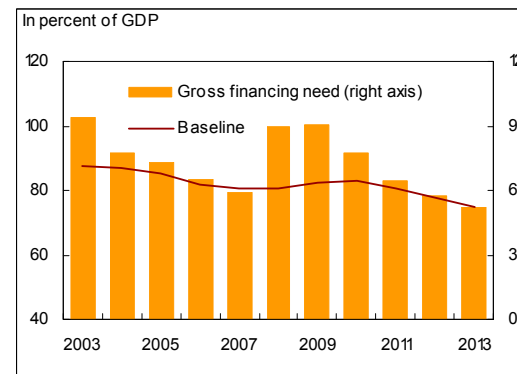
Achieving the FRBMA target of no current deficit in 2009/10 will likely be infeasible.



Public debt remains high.



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



Sources: Country authorities; and Fund staff calculations.

1/ Includes subsidy-related bond issuance.

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

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

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

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

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

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

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

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

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

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

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

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

Table 2. India: Selected Social and Economic Indicators, 2004/05–2009/10 1/

I. Social Indicators						
GDP (2007/08)			Poverty (Percent of population)			
Nominal GDP (billions of U.S. dollars):	1,173		Headcount ratio (2003/04):		27.5	
GDP per capita (U.S. dollars):	999		Undernourished (2000):		21.0	
Population characteristics (2007)			Income distribution (2004, WDI)			
Total (in billions):	1.2		Richest 10 percent of households:		31.1	
Urban population (percent of total):	29.3		Poorest 20 percent of households:		8.1	
Life expectancy at birth (years):	64.5		Gini index:		36.8	
II. Economic Indicators						
	2004/05	2005/06	2006/07	2007/08	2008/09 2/ Proj.	2009/10 2/ Proj.
Growth (y/y percent change)						
Real GDP (at factor cost)	7.5	9.4	9.6	9.0	6.3	5.3
Non-agricultural sector	9.5	10.3	11.0	10.0	7.1	5.9
Industrial production	8.4	8.2	11.5	8.5	...	...
Prices (y/y percent change, period average for annual data)						
Wholesale prices (1993/94 weights)	6.5	4.4	5.4	4.7	8.8	1.9
Consumer prices - industrial workers (2001 weights)	3.8	4.4	6.7	6.2	7.8	3.4
Saving and investment (percent of GDP)						
Gross saving 3/	31.8	34.3	34.8	36.0	34.6	34.9
Gross investment 3/	32.2	35.5	35.9	37.5	37.6	36.4
Fiscal position (percent of GDP) 4/ 5/						
Central government deficit	-4.1	-4.7	-4.4	-3.4	-7.1	-5.7
General government deficit	-7.3	-7.3	-6.3	-5.8	-9.9	-8.8
General government debt	86.5	84.2	80.6	80.1	80.7	82.9
Money and credit (y/y percent change, end-period)						
Broad money	12.3	21.2	21.5	20.8	...	...
Credit to commercial sector	26.0	32.2	25.8	20.6	...	...
Financial indicators (percent, end-period)						
91-day treasury bill yield	5.3	6.1	8.0	7.2	...	...
10-year government bond yield	6.7	7.5	8.0	7.9	...	...
Stock market (y/y percent change, end-period)	16.1	73.7	15.9	19.7	...	...
External trade 6/						
Merchandise exports (US\$ billions)	85.2	105.2	128.9	166.2	186.4	169.0
y/y percent change	28.5	23.4	22.6	28.9	12.2	-9.4
Merchandise imports (US\$ billions)	118.9	157.1	190.7	257.8	298.0	265.5
y/y percent change	48.6	32.1	21.4	35.2	15.6	-10.9
Net oil imports (US\$ billions)	22.9	32.3	38.3	52.2	60.0	38.6
Balance of payments (US\$ billions)						
Current account balance	-2.5	-9.9	-9.6	-17.0	-35.1	-18.6
(in percent of GDP)	-0.4	-1.2	-1.0	-1.5	-3.0	-1.5
Foreign direct investment, net	3.7	3.0	7.7	15.4	19.9	14.0
Portfolio investment, net (equity and debt)	9.3	12.5	7.1	29.6	-11.7	-2.5
Overall balance	26.2	15.1	36.6	92.2	-27.9	-3.3
External indicators						
Gross reserves (in billions of U.S. dollars, end-period)	141.5	151.6	199.2	309.7	246.8	243.5
(In months of imports) 7/	8.9	7.7	7.7	10.5	9.1	8.0
External debt (in billions of U.S. dollars, end-period) 8/	133.0	138.1	171.4	224.8	229.0	238.0
External debt (percent of GDP, end-period) 8/	19.0	17.1	18.7	19.2	19.5	18.7
Of which: short-term debt 9/	9.2	7.8	8.3	8.6	11.3	11.4
Ratio of gross reserves to short-term debt (end-period) 9/	2.2	2.4	2.6	3.1	1.9	1.7
Gross reserves to broad money (percent; end-period)	27.5	24.8	26.1	31.0	28.9	...
Debt service ratio 10/	6.0	10.1	4.9	5.3	5.5	5.7
Real effective exchange rate 11/						
(y/y percent change, period average for annual data)	2.2	4.4	-2.2	8.2	...	...
Exchange rate (rupee/US\$, end-period)	43.7	44.6	43.5	40.1	...	...
Memorandum items (in percent of GDP):						
Subsidy-related bond issuance 12/	0.0	0.5	1.0	0.6	1.3	0.3

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

1/ Data are for April-March fiscal years.

2/ Current staff projections.

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

4/ Divestment proceeds treated as below-the-line financing.

5/ Subsidy-related bond issuance included in total expenditure.

6/ Annual data are on balance of payments basis.

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

8/ For projection, data are reported relative to staff's estimated annual GDP.

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

10/ In percent of current account receipts excluding grants.

11/ IMF INS calculation.

12/ Issued by the central government to FCI, the state-owned oil refining/distribution companies, and fertilizer companies as compensation for losses incurred from the provision of subsidies.

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

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

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

1/ Data for April - March fiscal year.

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

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

4/ Excludes subsidy-related bond issuance.

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

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

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

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

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

10/ External debt measured at historical exchange rates.

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

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

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

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

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

2/ Based on RBI's estimate of provisional outturn for state finances.

3/ Based on RBI's revised estimates of state finances.

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

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

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

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

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

9/ The authorities treat states' divestment proceeds, including land sales, above-the-line as miscellaneous capital receipts. Staff's definition treats divestment receipts as a below-the-line financing item. Asset sales amount to 0.2 percent of GDP in 2007/08 and are budgeted at 0.3 percent of GDP in 2008/09.

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

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

	2004/05	2005/06	2006/07	2007/08	Projections				
					2008/09	2009/10	2010/11	2011/12	2012/13
Growth (percent change)									
Real GDP (at factor cost)	7.5	9.4	9.6	9.0	6.3	5.3	7.0	7.6	7.9
Non-agricultural sector	9.5	10.3	11.0	10.0	7.1	5.9	7.8	8.6	8.8
Real GDP (at factor cost, on calendar year basis)	7.2	9.1	9.8	9.3	7.3	5.1	6.5	7.5	7.8
Prices (percent change, period average)									
Wholesale prices (1993/94 weights)	6.5	4.4	5.4	4.7	8.8	1.9	4.0	3.9	3.9
Consumer prices	3.8	4.4	6.7	6.2	7.8	3.4	4.0	3.9	3.9
Interest rate on general government domestic debt (percent)	8.4	7.8	7.9	7.1	7.5	6.3	8.0	8.0	8.0
Saving and investment (percent of GDP)									
Gross saving 2/	31.8	34.3	34.8	36.0	34.6	34.9	34.5	34.7	35.2
Gross investment 3/	32.2	35.5	35.9	37.5	37.6	36.4	36.7	37.0	37.6
Fiscal position (percent of GDP)									
Central government balance - authorities 4/	-4.0	-4.1	-3.4	-2.8	-5.8	-5.4	-4.1	-3.3	-3.0
Central government balance - augmented 5/	-4.1	-4.7	-4.4	-3.4	-7.1	-5.7	-4.3	-3.5	-3.2
General government balance - augmented 5/	-7.3	-7.3	-6.3	-5.8	-9.9	-8.8	-7.3	-6.1	-5.6
General government debt	86.5	84.2	80.6	80.1	80.7	82.9	82.5	80.2	77.3
External trade (percent change, BOP basis)									
Merchandise exports (in U.S. dollar terms)	28.5	23.4	22.6	28.9	12.2	-9.4	10.2	12.5	12.7
Merchandise imports (in U.S. dollar terms)	48.6	32.1	21.4	35.2	15.6	-10.9	13.3	12.6	12.3
Balance of payments (in billions of U.S. dollars)									
Current account balance	-2.5	-9.9	-9.6	-17.0	-35.1	-18.6	-29.6	-35.3	-40.1
(in percent of GDP)	-0.4	-1.2	-1.1	-1.5	-3.0	-1.5	-2.1	-2.3	-2.4
(in percent of GDP, calendar year basis)	0.1	-1.3	-1.1	-1.0	-2.5	-1.8	-2.0	-2.3	-2.4
Foreign direct investment, net	3.7	3.0	8.4	15.4	19.9	14.0	20.7	19.6	19.9
Portfolio investment, net (equity and debt)	9.3	12.5	7.1	29.6	-11.7	-2.5	15.1	19.6	21.6
Overall balance	26.2	15.1	36.6	92.2	-27.9	-3.3	23.9	24.3	24.0
External indicators									
Gross reserves (in billions of U.S. dollars, end-period)	141.5	151.6	199.2	309.7	246.8	243.5	267.4	291.6	315.7
(in months of imports) 6/	8.9	7.7	7.7	10.5	9.1	8.0	7.8	7.3	7.0
External debt (in billions of U.S. dollars, end-period)	133.0	138.1	171.4	224.8	229.0	238.0	268.8	303.8	342.8
External debt (percent of GDP, end-period)	19.0	17.1	18.7	19.2	19.5	18.7	19.5	20.1	20.7
Of which : short-term debt 7/	9.2	7.8	8.3	8.6	11.3	11.4	12.0	12.2	12.3
Ratio of gross reserves to short-term debt (end-period) 7/	2.2	2.4	2.6	3.1	1.9	1.7	1.6	1.6	1.5
Debt service (percent of current account receipts)	6.0	10.1	4.9	5.3	5.5	5.7	7.0	8.5	8.4
Memorandum items (in percent of GDP):									
Subsidy-related bond issuance 8/	0.0	0.5	1.0	0.6	1.3	0.3	0.3	0.2	0.2

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

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

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

3/ Statistical discrepancy adjusted.

4/ Divestment proceeds are treated as revenue until 2005/06 (included); excludes subsidy-related bond issuance.

5/ Divestment is treated as financing; includes subsidy-related bond issuance.

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

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

8/ Issued by the central government to FCI, the state-owned oil refining/distribution companies, and fertilizer companies as compensation for losses incurred from the provision of subsidies.

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

	2004/05	2005/06	2006/07	2007/08	2008/09 2/
Financial indicators					
General government debt (percent of GDP)	86.5	84.2	80.6	80.1	80.7 (Projection)
Broad money (percent change, 12-month basis)	12.3	21.2	21.5	20.8	19.8 (December 2008)
Private sector credit (percent change, 12-month basis)	26.0	32.2	25.8	20.6	23.2 (December 2008)
91 day T-bill yield (percent; end-period)	5.3	6.1	8.0	7.2	4.8 (December 2008)
91 day T-bill yield (real, percent; end-period) 3/	-1.1	1.6	2.4	2.5	-1.0 (December 2008)
External indicators					
Exports (percent change, 12-month basis in US\$) 4/ 5/	28.5	23.4	22.6	28.9	(9.9) (November 2008)
Export volume (percent change, 12-month basis) 5/	11.7	15.5	16.5	15.3	14.9 (Projection)
Imports (percent change, 12-month basis in US\$) 4/ 5/	48.6	32.1	21.4	35.2	6.1 (November 2008)
Import volume (percent change, 12-month basis) 5/	28.0	20.0	13.5	13.2	12.8 (Projection)
Terms of trade (percent change, 12 month basis) 5/	-3.5	-4.8	-2.3	-3.1	-0.1 (Projection)
Current account balance (percent of GDP)	-0.4	-1.2	-1.0	-1.5	-3.0 (Projection)
Capital and financial account balance (percent of GDP)	4.0	3.1	4.9	9.2	0.6 (Projection)
Of which: Net portfolio investment (debt and equity)	1.3	1.5	0.8	2.5	-1.0 (Projection)
Other investment (loans, trade credits, etc.)	1.4	1.3	3.1	3.6	0.3 (Projection)
Net foreign direct investment	0.5	0.4	0.8	1.3	1.7 (Projection)
Foreign currency reserves (billions of US\$)	141.5	151.6	199.2	309.7	254.6 (December 2008)
RBI forward liabilities (billions of US\$)	0.0	0.0	0.0	-14.7	-0.1 (October 2008)
Official reserves (in months of imports of goods and services)	8.9	7.7	7.7	10.5	9.1 (Projection)
Ratio of foreign currency reserves to broad money (percent)	27.5	24.8	26.1	31.0	28.0 (December 2008)
Total short-term external debt to reserves (percent) 6/	45.8	41.6	38.3	32.4	53.9 (Projection)
Total external debt (percent of GDP)	19.0	17.1	18.7	19.2	19.5 (Projection)
Of which: public sector debt	8.9	7.3	6.7	6.1	6.3 (Projection)
Total external debt to exports of goods and services (percent)	103.5	84.8	84.5	87.7	80.9 (Projection)
External interest payments to exports of goods and services (percent)	2.4	3.2	2.7	3.2	3.2 (Projection)
External amortization payments to exports of goods and services (percent)	4.8	8.8	3.1	3.3	3.4 (Projection)
Exchange rate (per US\$, period average)	44.9	44.3	45.2	40.3	48.7 (December 2008)
REER (y/y change in percent; end-period)	1.4	4.2	0.1	5.2	-11.6 (December 2008)
Financial market indicators					
Stock market index (end-period)	6,493	11,280	13,072	15,644	9,647 (December 2008)
Foreign currency debt rating					
Moody's Investor Services	Baa3	Baa3	Baa3	Baa2	Baa2 (December 2008)
Standard and Poor's	BB+	BB+	BBB-	BBB-	BBB- (December 2008)
Fitch Ratings	BB+	BB+	BBB-	BBB-	BBB- (December 2008)

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

1/ Data for April-March fiscal year.

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

3/ Equals nominal yield minus actual WPI inflation.

4/ Data for 2008/09 are on a customs basis, whereas data for previous years are on a BOP basis.

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

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

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

	2004/05	2005/06	2006/07	2007/08	2008/09 Q1
Measures of financial strength and performance 1/					
Risk-weighted capital adequacy ratio (CAR)	12.8	12.3	12.3	13.0	12.7
Public sector banks	12.9	12.2	12.4	12.5	12.3
Old Private Sector Banks	12.5	11.7	12.1	14.1	13.9
New Private Sector Banks	12.1	12.6	12.0	14.4	14.1
Foreign banks	14.0	13.0	12.4	13.1	12.2
Number of institutions not meeting 9 percent CAR	0	1	0	0	...
Public sector banks	0	0	0	0	...
Old Private Sector Banks	0	1	0	0	...
New Private Sector Banks	0	0	0	0	...
Foreign banks	0	0	0	0	...
Net nonperforming loans (percent of outstanding net loans) 2/ 3/	2.0	1.2	1.0	1.0	1.1
Public sector banks	2.1	1.3	1.1	1.0	1.0
Old Private Sector Banks	2.7	1.7	1.0	0.7	0.8
New Private Sector Banks	1.9	0.8	1.0	1.2	1.5
Foreign banks	0.9	0.8	1.0	1.2	0.7
Gross nonperforming loans (percent of outstanding loans) 3/	5.2	3.3	2.5	2.3	2.4
Public sector banks	5.5	3.6	2.7	2.2	2.2
Old Private Sector Banks	6.0	4.4	3.0	2.3	2.4
New Private Sector Banks	3.6	1.7	1.9	2.5	3.2
Foreign banks	2.9	2.0	1.8	1.8	1.9
Number of institutions with net NPLs above 10 percent of advances	4	3	1	0	...
Public sector banks	0	0	0	0	...
Old Private Sector Banks	0	0	0	0	...
New Private Sector Banks	0	0	0	0	...
Foreign banks	4	3	1	0	...
Net profit (+)/loss (-) of commercial banks 4/	0.9	0.9	0.9	1.0	0.9
Public sector banks	0.9	0.8	0.8	0.9	0.6
Old Private Sector Banks	0.3	0.6	0.7	1.0	0.8
New Private Sector Banks	1.1	1.0	0.9	1.0	0.6
Foreign banks	1.3	1.5	1.7	1.8	2.7
Balance sheet structure of all scheduled banks					
Loan/deposit ratio	65.5	72.0	74.5	71.5	73.9
Investment in government securities/deposit ratio	43.5	34.3	30.5	32.7	30.3
Lending to sensitive sectors (in percent of loans and advances)					
Real estate	12.7	17.2	18.8	18.0	...
Capital market	1.4	1.5	1.8	2.5	...
Commodities	0.2	0.3	0.0	0.1	...

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

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

2/ Gross nonperforming loans less provisions.

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

4/ In percent of total assets.



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APPENDIX I

Public Information Notice (PIN) No. 09/xx
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International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2008 Article IV Consultation with India

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

Background

The global financial crisis is exacerbating a cyclical downturn. After four years with average growth of 8¾ percent, India's economy is slowing, pulled down mainly by domestic private demand. Staff project growth to moderate to 6¼ percent in 2008/09 and further to 5¼ percent in 2009/10. Corporate investment—the major growth driver during recent years—is expected to slow sharply, with profitability declining, financing conditions tightening, and confidence weakening. Policy measures to stimulate the economy and a good harvest should support consumption somewhat. The uncertainty surrounding the forecast is unusually large, with significant downside risks. The main upside risk stems from a larger-than-anticipated impact of the stimulus measures.

After rising to nearly 13 percent (y/y) in August 2008, headline inflation (Wholesale Price Index) dropped to 6½ percent (y/y) by December. With commodity prices waning and demand slackening, inflation is expected to fall further to 3 percent (y/y) by March 2009 and to 2 percent on average in 2009/10.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

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

After last year's record of 9.2 percent of GDP, capital inflows are expected to decline sharply this fiscal year: so far, portfolio investment have recorded a large outflow and external commercial borrowing has slowed considerably, though FDI has held up relatively well. Looking ahead, the global crisis is expected to keep external funding conditions tight. While reserves have declined sharply this fiscal year, from a historic peak of \$315 billion in May 2008 to \$[255] billion as of end-2008, they remain adequate compared to the country's gross financing requirement and imports.

The global crisis has hit Indian financial assets hard. The stock market index declined by over 50 percent in 2008 and the rupee depreciated 23 percent versus the U.S. dollar and 13 percent in nominal effective terms. The real effective exchange rate depreciated by 10 percent and is in line with its 10-year average.

Domestic financing conditions remain tight, despite significant central bank measures. The RBI's measures—including cutting policy rates, lowering the cash reserve ratio and the statutory liquidity ratio, and easing controls on capital inflows—have eased the domestic liquidity pressures that appeared in September and October and brought down interbank rates significantly. Nevertheless, the TED and commercial paper spreads have remained elevated and commercial lending rates have fallen much less than policy rates. Given the rapid decline in inflation, this means that real interest rates have actually increased over the past months. Credit growth remains relatively high, though this in part reflects the switch of corporate funding to banks as financing from other sources dried up. These conditions are expected to persist into 2009.

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

Although the 2008/09 budget targeted further consolidation in line with the previous five years, spending rose sharply even before the onset of the crisis, reflecting a soaring subsidy bill, agricultural debt forgiveness, an expansion of a rural employment guarantee scheme, and a 21 percent civil service wage hike. In addition, tax revenue has slowed sharply as the economy is losing steam. Staff project the central government deficit at about 7 percent of GDP this year, including 1¼ percent of subsidy-related bond issuance. The general government deficit, which includes the states' deficit, is forecast to rise to nearly 10 percent of GDP. Public debt remains elevated at about 80 percent of GDP.

Executive Board Assessment

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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.

Table 1. India: Selected Social and Economic Indicators, 2004/05–2009/10 1/

I. Social Indicators						
GDP (2007/08)			Poverty (Percent of population)			
Nominal GDP (billions of U.S. dollars):	1,173		Headcount ratio (2003/04):		27.5	
GDP per capita (U.S. dollars):	999		Undernourished (2000):		21.0	
Population characteristics (2007)			Income distribution (2004, WDI)			
Total (in billions):	1.2		Richest 10 percent of households:		31.1	
Urban population (percent of total):	29.3		Poorest 20 percent of households:		8.1	
Life expectancy at birth (years):	64.5		Gini index:		36.8	
II. Economic Indicators						
	2004/05	2005/06	2006/07	2007/08	2008/09 2/ Proj.	2009/10 2/ Proj.
Growth (y/y percent change)						
Real GDP (at factor cost)	7.5	9.4	9.6	9.0	6.3	5.3
Non-agricultural sector	9.5	10.3	11.0	10.0	7.1	5.9
Industrial production	8.4	8.2	11.5	8.5	...	...
Prices (y/y percent change, period average for annual data)						
Wholesale prices (1993/94 weights)	6.5	4.4	5.4	4.7	8.8	1.9
Consumer prices - industrial workers (2001 weights)	3.8	4.4	6.7	6.2	7.8	3.4
Saving and investment (percent of GDP)						
Gross saving 3/	31.8	34.3	34.8	36.0	34.6	34.9
Gross investment 3/	32.2	35.5	35.9	37.5	37.6	36.4
Fiscal position (percent of GDP) 4/ 5/						
Central government deficit	-4.1	-4.7	-4.4	-3.4	-7.1	-5.7
General government deficit	-7.3	-7.3	-6.3	-5.8	-9.9	-8.8
General government debt	86.5	84.2	80.6	80.1	80.7	82.9
Money and credit (y/y percent change, end-period)						
Broad money	12.3	21.2	21.5	20.8	...	...
Credit to commercial sector	26.0	32.2	25.8	20.6	...	...
Financial indicators (percent, end-period)						
91-day treasury bill yield	5.3	6.1	8.0	7.2	...	...
10-year government bond yield	6.7	7.5	8.0	7.9	...	...
Stock market (y/y percent change, end-period)	16.1	73.7	15.9	19.7	...	...
External trade 6/						
Merchandise exports (US\$ billions)	85.2	105.2	128.9	166.2	186.4	169.0
y/y percent change	28.5	23.4	22.6	28.9	12.2	-9.4
Merchandise imports (US\$ billions)	118.9	157.1	190.7	257.8	298.0	265.5
y/y percent change	48.6	32.1	21.4	35.2	15.6	-10.9
Net oil imports (US\$ billions)	22.9	32.3	38.3	52.2	60.0	38.6
Balance of payments (US\$ billions)						
Current account balance	-2.5	-9.9	-9.6	-17.0	-35.1	-18.6
(in percent of GDP)	-0.4	-1.2	-1.0	-1.5	-3.0	-1.5
Foreign direct investment, net	3.7	3.0	7.7	15.4	19.9	14.0
Portfolio investment, net (equity and debt)	9.3	12.5	7.1	29.6	-11.7	-2.5
Overall balance	26.2	15.1	36.6	92.2	-27.9	-3.3
External indicators						
Gross reserves (in billions of U.S. dollars, end-period)	141.5	151.6	199.2	309.7	246.8	243.5
(In months of imports) 7/	8.9	7.7	7.7	10.5	9.1	8.0
External debt (in billions of U.S. dollars, end-period) 8/	133.0	138.1	171.4	224.8	229.0	238.0
External debt (percent of GDP, end-period) 8/	19.0	17.1	18.7	19.2	19.5	18.7
Of which: short-term debt 9/	9.2	7.8	8.3	8.6	11.3	11.4
Ratio of gross reserves to short-term debt (end-period) 9/	2.2	2.4	2.6	3.1	1.9	1.7
Gross reserves to broad money (percent; end-period)	27.5	24.8	26.1	31.0	28.9	...
Debt service ratio 10/	6.0	10.1	4.9	5.3	5.5	5.7
Real effective exchange rate 11/						
(y/y percent change, period average for annual data)	2.2	4.4	-2.2	8.2	...	...
Exchange rate (rupee/US\$, end-period)	43.7	44.6	43.5	40.1	...	...
Memorandum items (in percent of GDP):						
Subsidy-related bond issuance 12/	0.0	0.5	1.0	0.6	1.3	0.3

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

1/ Data are for April-March fiscal years.

2/ Current staff projections.

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

4/ Divestment proceeds treated as below-the-line financing.

5/ Subsidy-related bond issuance included in total expenditure.

6/ Annual data are on balance of payments basis.

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

8/ For projection, data are reported relative to staff's estimated annual GDP.

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

10/ In percent of current account receipts excluding grants.

11/ IMF INS calculation.

12/ Issued by the central government to FCI, the state-owned oil refining/distribution companies, and fertilizer companies as compensation for losses incurred from the provision of subsidies.