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IMF Executive Board Concludes 2008 Article IV Consultation with India

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

Background

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

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

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

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

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

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

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

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

Although the 2008/09 budget targeted further consolidation in line with the previous five years, spending rose sharply even before the onset of the crisis, reflecting a soaring subsidy bill, agricultural debt forgiveness, an expansion of a rural employment guarantee scheme, and a

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

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

Executive Board Assessment

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

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

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

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

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

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

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

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

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

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

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

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

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