Report No: AUS5757

October 2013

India Development Update

Economic Policy and Poverty Team

South Asia Region

The World Bank Group

Table of Contents

This update was prepared by Denis Medvedev and Smriti Seth (SASEP) under the guidance of Vinaya Swaroop (Sector Manager, SASEP), Deepak Bhattasali (Lead Economist, SASEP), and Zahid Hussain (Lead Economist, SASEP), and on the basis of discussions with experts in New Delhi's think tanks and policy making circles. Neeti Katoch, Varsha Marathe, and Niraj Verma (SASFP) authored the financial sector analysis, while Maria Mini Jos and Rinku Murgai (SASEP) authored the analysis of employment and poverty trends. The analysis of the currency developments was prepared by Ernesto May (SASPM), Denis Medvedev (SASEP), and Martin Rama (SARCE) with inputs from Poonam Gupta (DECOS), Yuki Ikeda (EASHS), Neeti Katoch (SASFP), Sujata Lamba (FCDDR), Sanket Mohapatra (DECPG), Rinku Murgai (SASEP), and Niraj Verma (SASFP). The team benefitted from valuable comments and contributions by Martin Rama (SARCE), Sanket Mohapatra (DECPG), and Andrew Burns (DECPG). Onno Ruhl (Country Director, SACIN) and Ernesto May (Sector Director, SASPM) linked the team to the Bank's overall strategy and steered them in that direction.

The updates are published twice yearly and give an overview of developments in the Indian economy in a global context, and also highlight topics related to medium- and long-term growth which are in the public debate at the time of writing. A special topic of the current update is the recent depreciation in the rupee, its causes, and potential consequences for the economy.

Executive Summary

Although the recent market turmoil has been driven primarily by external factors, it has magnified India's macroeconomic vulnerabilities. India was just one of a large number of emerging market economies whose currency and capital account were adversely affected by a large outflow of portfolio investment this summer. While these portfolio flows have been driven largely by investor fears of a shift in the US monetary policy, countries with greater macroeconomic vulnerabilities have come under greater scrutiny. India's below-potential GDP growth, due to continued slowdown in investment, high current account deficit with growing structural vulnerabilities, rising food and fuel prices, and an improving but still elevated fiscal deficit, have added to investor fears about the economy's ability to cope well with external shocks.

The current downturn presents an opportunity to push ahead with critical reforms. The current situation is unlikely to place an insurmountable stress on the economy, but it does offer an opportunity for measures to strengthen the business environment, attract more FDI, and increase productivity. These measures could include steps to reinforce the financial sector via capitalization and broader banking/financial sector reforms, simplify the regulatory environment for firms, and strengthen fiscal balances through continued fiscal discipline and the adoption of GST. The reform momentum has accelerated in the last several months, and possible further steps in the above directions by the authorities could bode well for stronger growth in the medium and long-term.

The growth rate of the Indian economy decelerated to 4.4 percent in the first quarter of FY2014. A sharp slowdown in manufacturing and continued weakness in the mining sector were offset by a small acceleration in services – particularly public services – and a strong rebound in agriculture, supported by early and plentiful monsoons. On balance, however, growth remains muted and business confidence has fallen below the contraction threshold for the past two months.

The rupee depreciated sharply in May – August 2013, mainly caused by market fears of an early end to the Federal Reserve's stimulus program. As global investors shifted funds into US treasuries, the May-August fall in the rupee closely mirrored movements in other emerging market currencies and US T-bonds. Although India's macroeconomic vulnerabilities are high – as reflected in large current account and fiscal deficits – the market sentiment has recently improved, in response to the Fed's decision to delay tapering as well as a clearer articulation of long-term policy goals by the Indian authorities.

The current account deficit moderated and exports performance improved. After reaching a record high of 6.5 percent of GDP in the third quarter FY2013, the current account deficit improved to 3.6 percent of GDP in the fourth quarter. Although the merchandise trade deficit worsened in the first few months of the current fiscal year, imports began to contract and export performance improved substantially in the past few months, aided by rupee depreciation.

Core inflation has retreated to well below the RBI comfort threshold. Core inflation has fallen to 2.4 percent – well within the 4 percent comfort range of the Reserve Bank – and has brought down overall WPI inflation to 5.3 percent for the current fiscal year. CPI inflation, on the other hand, remained above 9 percent, pushed by rising prices of food and fuel.

Vulnerabilities in the corporate sector are on the rise. While corporate debt levels have risen, earnings and profitability remained under pressure, pushing up debt coverage ratios. These vulnerabilities were transmitted to the banking sector, with a concomitant increase in non-performing assets, particularly among public sector banks. The banking system remains robust overall, although stress levels are elevated and rising rapidly, meriting close attention.

Fiscal performance improved in FY2013, but fiscal targets have come under stress. While the FY2013 central government deficit of 4.9

percent of GDP is well below budget estimates, this year's target of 4.8 percent is likely to come under pressure. In the first four months of the current fiscal year, the central government has already incurred a deficit equivalent to 62.8 percent of the target for the entire year, as tax collections remain subdued in line with weak economic activity whereas subsidy spending has risen sharply with the depreciation in the rupee.

The decline in poverty has accelerated, but vulnerability remains high. Between 2005 and 2012, India lifted 137 million people out of poverty and reduced the poverty headcount (at the national poverty line) to 22 percent of the population. The pace of poverty reduction has been accelerating over the years, and a much larger fraction of the decline is taking place in low-income states. On the other hand, inequality continues to rise – albeit at a decelerating rate – and more than half of India's population remains vulnerable, living between one and two poverty lines.

The depreciation in the rupee is unlikely to have major adverse effects and provides an opportunity to accelerate growth through further progress on the reform agenda. Adverse impacts of the depreciation on investment growth are likely to be somewhat offset by gains in export performance due to improved external competitiveness. Even with new pressure on fiscal balances, external and domestic financing needs are likely to be financed without much difficulty as real interest rates are close to zero and government short-term debt is around 1 percent of GDP. Although external short-term debt at residual maturity is relatively high at 9 percent of GDP (44 percent of total external debt), short-term sovereign external debt is just 0.3 percent of GDP and the vast majority of the remainder is accounted for by deposits by Indians abroad (which have a reasonable likelihood of being rolled over) and short-term trade credits (which are implicitly hedged, to an extent). Increases in inflation are likely to be limited by a small share of imported food in the overall consumption basket and the diesel pricing mechanism which limits increases to Rs.0.50 per liter per month. While rising prices will put some pressure on household budgets, real income losses – particularly in the rural areas – could well be offset by a favorable monsoon. The greatest risks are in the corporate and banking sector, where depreciation has exacerbated pressures from falling profitability and rising non-performing assets. Overall, however, the situation is likely to be manageable and instead offers the authorities a window of opportunity to further boost competitiveness through reform actions.

The macroeconomic environment is expected to improve and growth is expected to accelerate gradually over the next two years. The baseline scenario in this Update is conditional on further improvements in the macroeconomic framework, benign global conditions, and continued efforts by the authorities to strengthen the business environment and improve fiscal sustainability. Under these assumptions, the pace of economic activity is expected to accelerate appreciably in the second half of FY2014, bringing economic growth to 4.7 percent for the entire fiscal year. Growth is expected to improve further to 6.2 percent in FY2015 as manufacturing growth accelerates and new and existing investment projects come on stream. The acceleration in growth is unlikely to create inflationary pressures as several years of growth below potential have opened a positive output gap, and inflation is expected to decelerate to 5.3 percent and 5.2 percent in FY2014 and FY2015. The pick-up in exports bodes well for closing of the current account gap, but the merchandise trade deficit is likely to remain elevated in the short- and medium-term as fuel imports, which tend to be relatively less sensitive to price changes, account for more than one-third of the total import basket. In addition, the acceleration of growth in the second half of FY2014 and FY2015 is likely to require higher imports of capital goods. Under these assumptions, the current account deficit is expected to decline to 4.1 percent of GDP in FY2014 and 3.7 percent of GDP in FY2015. Financing of the gap is expected to come in roughly equal parts from FDI and institutional flows in FY2014, with a growing contribution from FDI in FY2015.

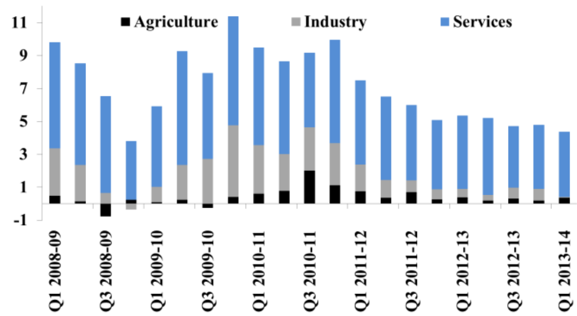
1. Recent Economic Developments

1.1 Real sector activity

Economic growth decelerated to 4.4 percent in the first quarter of the new fiscal year. Growth in real GDP at factor cost came in below 5 percent for the third quarter in a row in Q1 FY2014, slowing to 4.4 percent from 4.8 percent in Q4 FY2013.[1,2] This marks a sixth consecutive quarter of sub-6 percent growth, making the current episode the most persistent slowdown in nearly two decades. On a seasonally adjusted annual (saar) basis, GDP growth fell to a seventeen-quarter low of 4.2 percent, its worst performance since the onset of the global financial crisis in FY2009.[3] Output in mining continued to contract, while growth in manufacturing – which had already shrunk by 0.1 percent saar in the previous quarter – fell sharply to -9.4 percent saar. On the other hand, growth in services strengthened somewhat to 8.0 percent saar, and growth in agriculture more than doubled to 3.7 percent saar due to a favorable monsoon.

Industrial output contracted in Q1 FY2014 but rebounded strongly in the beginning of Q2. Growth in industrial output started weakening in FY2012 as mining activity stalled and manufacturing output decelerated. These weaknesses deepened in Q1 FY2014, as the pace of decline in the industrial production (IP) index accelerated from -3.1 percent saar in March 2013 to -18.0 percent saar in April and -24.9 percent saar in May. The slowdown has been most pronounced in the production of discretionary consumer goods, such as vehicles and televisions; and essential industrial goods, such as basic metals and machines. In June, however, the pace of decline slowed to -2.9 percent saar, suggesting that the downward momentum was abating. In July, industrial output rebounded strongly by 2.6 percent y-o-y (58.1 percent saar), led by a 3.0 percent y-o-y increase in manufacturing and particularly 15.6 percent y-o-y growth in the production of capital goods.

Economic growth decelerated in Q1 FY2014
(percent y-o-y growth)

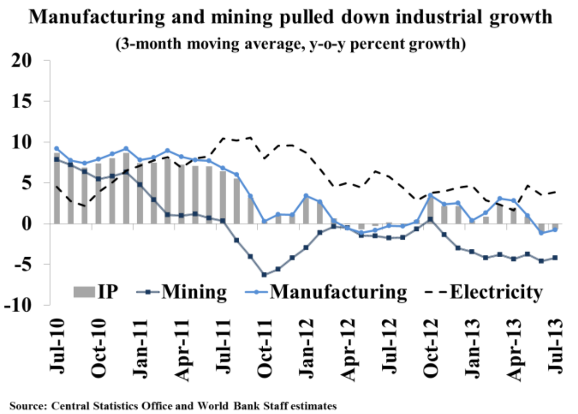


Source: Central Statistics Office and World Bank Staff estimates

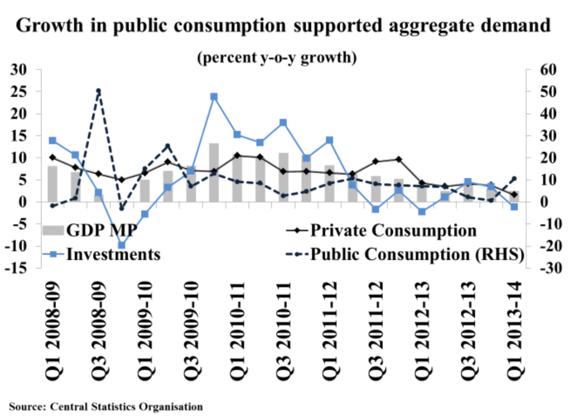
Business and consumer sentiment remain subdued. Reflecting weakness in the manufacturing sector, investment contracted by 1.2 percent y-o-y in Q1 FY2014 after registering single-digit growth during the previous three quarters. Business confidence, as captured by the HSBC Composite Purchasing Managers' Index which surveys private manufacturing and service firms, has fallen to 47.6 in August, marking the worst outturn in over four years and a second consecutive month below the contraction threshold of 50. Similarly, the business expectations index, as estimated by the Reserve Bank of India (RBI) industrial outlook survey, fell by 4.4 percent for Q1 FY2014 to its lowest level in three financial years. Consumers are also hesitant, as domestic passenger car sales, which declined during FY2013 for the first time in more than a decade, continued the downward slide during Q1 FY2014. Overall, growth in private consumption expenditure decelerated sharply to 1.3 percent saar in Q1 FY2014 from 3.5 percent saar the previous quarter. For the first time since FY2004 consumption grew at less than 2.0 percent saar. Government expenditure, on the other hand,

[1] Throughout the document, FY2014 refers to fiscal year ending March 31, 2014.
[2] In accordance with standard practice in India, GDP growth is reported at factor cost rather than market prices. Growth rates of the two aggregates are nearly identical over long periods (e.g., annual average growth of 4.92 percent for factor cost vs. 4.93 percent for market prices between 1951 and 2013), but can deviate from year to year as sectors which attract higher/lower rates of indirect taxation grow at different rates. Growth in GDP at market prices slowed to 2.4 percent y-o-y in Q1 FY2014.
[3] Seasonally adjusted using the TRAMO-SEATS method (developed by the Bank of Spain).

accelerated sharply to 39 percent saar (10.5 percent y-o-y) in Q1 FY2014, following a squeeze on spending during the second half of FY2013. In fact, public spending accounted for the majority of growth in aggregate demand during the quarter.



Agriculture staged a strong rebound. Supported by favorable monsoons, agricultural production –which grew by just 1.9 percent in FY2013 – picked up the pace to 3.7 percent saar in the first quarter of FY2014. As of end-September 2013, India benefitted from 5 percent higher rainfall than normal, encouraging farmers to increase total sown area by 5 percent y-o-y to over 100 million ha for the *kharif* (summer) cropping season. Although the improved weather is good news for the incomes of the rural population, the relatively small contribution of agriculture to total output (13 percent) limits the extent to which better agricultural performance can support growth.



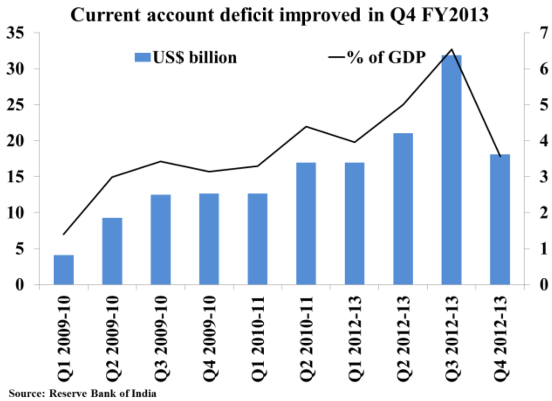
Growth in services remained robust, mainly on the back of a greater contribution from the public sector. Growth in logistical services related to trade, communication, transportation and financial services declined from 7.7 to 5.8 percent saar in Q1 FY2014, as these sectors were affected by the slowdown in industrial activity. On the other hand, growth of community, social and personal services – primarily provided by the public sector – accelerated sharply to 16.5 percent saar. The contribution from this sector was sufficient to raise the growth rate of the services sector from 7.5 percent saar in the last quarter of FY2013 to 8.0 percent saar in Q1 FY2014.

1.2 Balance of payments

After reaching a record high in Q3 FY2013, the current account deficit improved in the fourth quarter. The current account balance has gone through a major shift in the past decade, deteriorating from a surplus of 0.2 percent of GDP in the five years before the global crisis (FY2003-2007) to an average deficit of 2.6 percent of GDP during FY2008-2012, and reaching consecutive record highs of 4.2 and 4.8 percent of GDP in FY2012 and FY2013. Most of the deterioration in FY2013, however, took place during the first three quarters when the current account deficit rose to 5.2 percent of GDP. As merchandise exports strengthened in Q4 FY2013, the current account deficit improved to 3.6 percent of GDP. Strong portfolio inflows – which rose from 0.9 to 1.5 percent of GDP during the fiscal year – played an increasingly important role in financing the deficit while external commercial borrowing (ECB) remained stable at 0.5 percent of GDP. Even with a 10 percent y-o-y decrease in FDI (in US$), total capital inflows rose by nearly 32 percent, comfortably financing the current account deficit and adding almost US$4 billion to the stock of international reserves.

The growing trade deficit accounted for the majority of the widening in the current account gap. The merchandise trade deficit rose to 10.6 percent of GDP in FY2013 from 10.2 percent in the previous year as merchandise exports (in US$) fell by 1.1 percent y-o-y while imports increased by 0.5 percent. Weak demand from China, Indonesia, Japan, Hong Kong, and

Singapore – exports to which account for 17 percent of India's international shipments – resulted in exports to these destinations falling by more than 16 percent in FY2013. Imports growth decelerated markedly from 32.3 percent in FY2012 but remained positive primarily on account of petroleum imports, which rose by 9.3 percent despite a decline in international prices. Most of the deterioration in the trade balance, however, occurred during April-December 2012, while Q4 FY2013 was characterized by a pickup in merchandise exports and moderation in imports. A worsening in the balance on income account (net repatriation of profits) added another 0.3 percent of GDP to the current account deficit, while remittances increased marginally by 0.1 percent of GDP.



The slowdown in mining exacerbated the widening of the trade deficit. India's exports of iron ore grew rapidly in the early 2000s, making the country one of the largest global exporters by the end of the decade. However, even as India's total exports grew from US$179 billion in FY2010 to US$300 billion in FY2013, its exports of iron ore fell from US$6 billion to under US$2 billion. Meanwhile, imports of coal increased by more than 75 percent in the last two fiscal years compared with the previous two, reaching US$15 billion in FY2013. The combination of changing trade flows in these two commodities alone was responsible for 9 percent of the total deterioration in the merchandise trade deficit between FY2010 and FY2013.

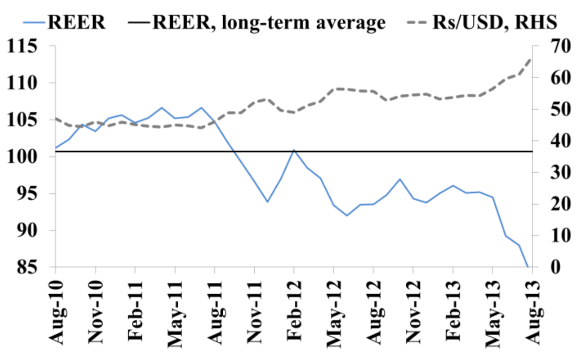
Appetite for gold remains high. In FY2013, imports of gold fell by 4.7 percent y-o-y, but the entire decline took place in the first six months of the fiscal year and the share of gold in total merchandise import basket remains high at almost 11 percent. After increasing by almost 40 percent y-o-y in Q3 FY2013, growth in gold imports moderated to 7 percent in Q4 after the authorities raised import duties from 4 to 6 percent and doubled the duty on raw gold to 5 percent in January. However, as international gold prices declined by more than 13 percent in Q1 FY2014, gold imports spiked by 79 percent y-o-y (3 percent q-o-q). The authorities took further steps in June and July to increase gold duties, now at 10 percent, as well as limit coin and medallion purchases and link imports to export volumes (gold is an important input to India's jewelry sector, which accounts for 14 percent of total merchandise exports).

Financing of the current account deficit has shifted towards portfolio investment and trade credits. Compared with FY2012, when FDI financed 28 percent of the current account deficit, the share of FDI in financing the current account gap declined to 22.5 percent in FY2013, replaced by greater contributions from portfolio flows, trade credits, and deposits by non-resident Indians (NRI). In order to encourage new FDI, the central government has raised caps and eased norms for FDI in retail, power exchanges, insurance, aviation, defense, and broadcasting. However, the authorities left the adoption of new rules in multi-brand retail to individual states, and no new multinational retailers have entered the Indian market as of yet.

Foreign exchange cover of external liabilities weakened somewhat. Total external debt increased by 12.9 percent to US$390 billion (or 21.2 percent of GDP) during FY2013, bringing down the ratio of foreign exchange reserves-to-total external debt to 74.9 percent, its lowest level in a decade. The increase in total debt was driven mostly by a rise in short term-trade credit, external commercial borrowings and NRI deposits, which grew by 33.3 percent, 15.4 percent, and 20.8 percent. Consequently, external short-term debt (residual maturity) increased to 44.2 percent of total external debt from 42.7 percent in FY2012. Sovereign external debt remained a small portion of total external debt, decreasing by US$0.2 billion to 4.4 percent of GDP.

Market fears of an early end to the Federal Reserve's quantitative easing program put the rupee under stress this summer as investors pulled back sharply from emerging markets. Similar to other emerging markets, the Indian rupee came under stress following the Fed Chairman's Congressional testimony on May 22, which raised speculation of an early "tapering" of the quantitative easing or asset purchasing program. As global investors withdrew US$15 billion of portfolio investment from Indian markets in June-August, the rupee fell by 18 percent vis-à-vis the US$ during this period and touched an all-time low of 68.4/ US$ on August 28, 2013. However, the rupee recovered more than a third of its losses in September as market fears were allayed by the Fed's September decision to continue asset purchases as well as the appointment of a new RBI Governor and an improvement in India's export performance. The real effective exchange rate (REER) mostly mirrored the movement of the nominal exchange rate: it fell by 11.6 percent between May and August, remaining below its long-term average, and is expected to have recovered somewhat in September.

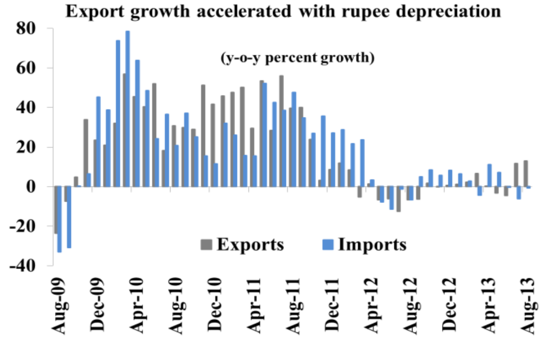
Rupee depreciated 18 percent between May and August 2013



Source: Reserve Bank of India

The rupee's depreciation helped improve export competitiveness and close the merchandise trade gap. Although exports did not seem to respond to the rupee's depreciation in June, export performance recovered strongly in July and August. During these two months, merchandise exports (in US$) grew at an eighteen month high of 12.3 percent y-o-y. Imports, which already fell by 0.4 percent in June, contracted further by 3.6 percent y-o-y in July-August. Consequently, the increase in the trade deficit for the fiscal year-to-date was limited to just 0.7 percent (US$74.4 billion).

Export growth accelerated with rupee depreciation

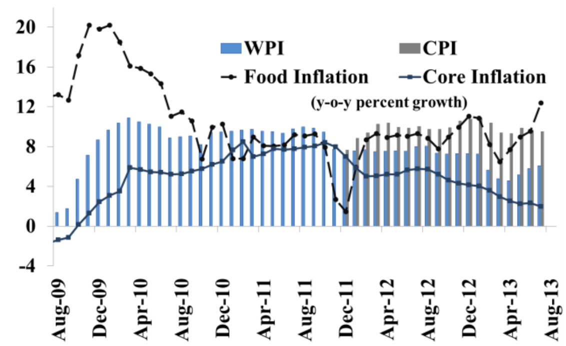


Source: Ministry of Commerce and Industry

1.3 Inflation

Continued downward momentum in core inflation has limited price increases. On a fiscal year-to-date basis, headline wholesale (WPI) inflation fell to 5.3 percent y-o-y, after averaging 7.4 percent in FY2013. Core inflation, measured as price growth of manufactured non-food products and used as a proxy for price elastic consumption demand by the RBI, decelerated to 2.4 percent y-o-y over the same period. This represents a major improvement compared with average core inflation of 4.9 percent during FY2013, and places core inflation well within the RBI comfort level of 4 percent.

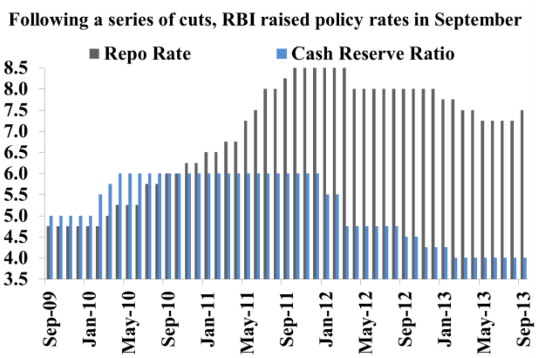
Headline inflation remained subdued



Source: Ministry of Commerce and Central Statistics Office

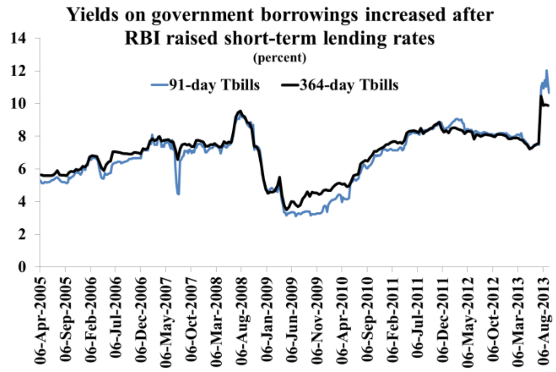
Food and fuel price growth accelerated. Growth in food prices appeared to be slowing at the start of FY2014, as WPI food inflation decelerated to 7.1 percent y-o-y in April-May from an average of 9.3 percent during FY2013.

However, starting in June, food price growth ticked up again to 10.3 percent y-o-y due to higher vegetable and cereals prices. Growth in fuel prices has also accelerated with gradual deregulation of diesel prices and mark-to-market petrol prices which have been affected by the depreciation in the rupee. Fuel prices began accelerating in April and fuel inflation gradually increased to 11.3 percent y-o-y in August 2013 from an average of 10.3 percent in FY2013. As a result, growth in consumer prices – where food and fuel account for nearly 60 percent of the entire basket – remained elevated at 9.5 percent in the current fiscal year (although down from an average of 10.2 percent in FY2013).



Source: Reserve Bank of India

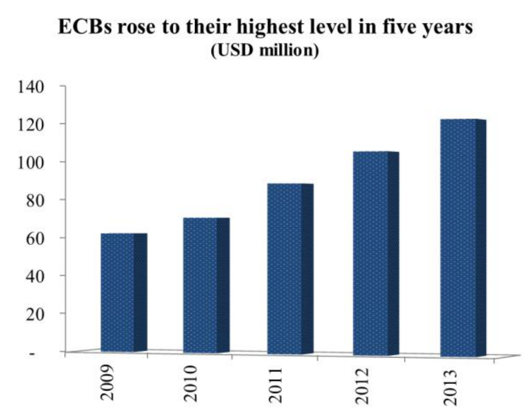
Accelerating prices and depreciating rupee led to reversal of earlier monetary loosening. The RBI reduced the policy repo rate by 25 bps in each of its January, March and May meetings, bringing the rate down to 7.25 percent after holding it constant for the previous seven meetings. However, in the two meetings since May the RBI refrained from further monetary policy easing on account of high food inflation and depreciating rupee and its potential pass-through to overall inflation. Beginning in July, the monetary policy began to tighten. First, the RBI increased short-term wholesale interest rates from 8.25 percent to 10.25 percent and imposed caps on banks' short-term borrowings, pushing up short-term interest rates and yields on short-term government securities. In September, the RBI moderated short-term rates by 75 bps to 9.5 percent but also raised the policy repo rate by 25 bps to 7.5 percent. These moves were motivated by an improvement in the external environment as well as the need to anchor inflationary expectations and respond proactively to the expectations of the Fed's "tapering."



Source: Reserve Bank of India

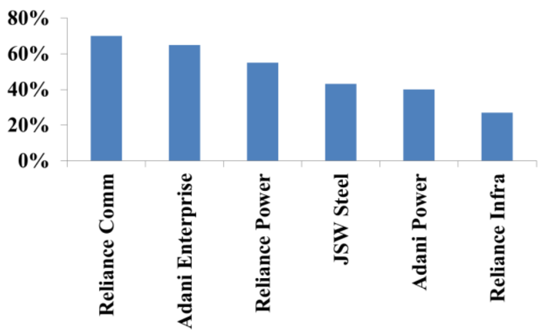
1.4 Financial sector

Corporate debt levels increased, even as profitability remained stressed. A recent report by Credit Suisse shows that ten large corporates, accounting for about 13 percent of banking loans and nearly all of banking system's net worth (about 98 percent), have a combined debt level in excess of US$100 billion. The debt coverage ratios are under pressure, with some groups having an interest cover well below 1. Given the high leverage levels, poor profitability and lender pressure, virtually all of the ten debt-heavy groups have initiated processes to divest part of their assets (cement plants/power/road projects). In the context of an over-leveraged domestic infrastructure sector, this trend is worrying as demand for such assets is likely to be limited.



Depreciation of the rupee has added to the corporate and financial sector stress. India's foreign debt has risen by 12 percent annually in last five years, with the share of its largest component, external commercial borrowings, steadily growing during the period. The spurt in foreign exchange borrowings in recent years was driven by historically low rates (0.80 percent in 2010) for Libor US$ borrowings, while peak base rate for rupee borrowings was about 10 percent, encouraging arbitrage particularly for the capital-intensive infrastructure sector. With foreign currency debt becoming an important source of funding for many corporates and financial institutions, non-government external debt constituted around 16 percent of GDP and 80 percent of total external debt in FY2013. The falling rupee could thus impose higher repayment costs on the private sector and add to the already existing stress of decelerating revenue growth. Such corporate stresses could in turn exert stress on the financial sector through slippages in rupee exposures of the banks to such corporates. A report by Credit Suisse indicates that in FY2013, 40-70 percent of debt burden of the large corporates was foreign-currency denominated.

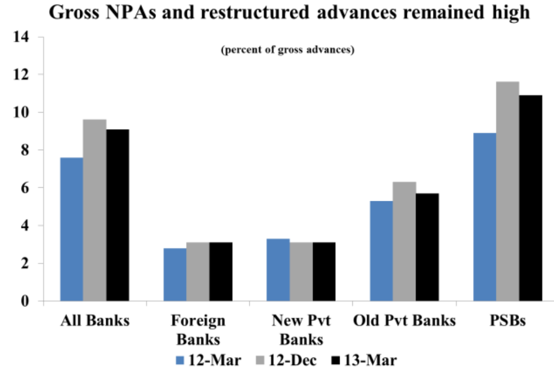
Foreign exchange loans as percent of total loans



Source: Credit Suisse Report-House of Debt Revisited

High debt levels and limited hedging practices could exacerbate risks faced by the corporate sector. Although explicit hedging by corporates in India is limited – a recent study by Fitch of 290 investment-grade corporates shows that only 42 percent of the corporates with foreign-exchange exposure followed hedging practices – the majority of debt held by internationally rated industrial corporates in India is either naturally hedged through import-parity pricing or has hedging arrangements of around 50 percent of their FX (foreign currency) exposure. However, high debt levels could exacerbate risk stemming from FX translation adjustments, particularly for companies with substantial foreign currency-denominated debt which is typically held at offshore subsidiaries.[4] Higher reported debt levels will have a negative impact on a number of key credit metrics including financial leverage. In addition, the combination of a sluggish economy, higher interest rates and a depreciating rupee is likely to impact the corporate sector's debt servicing capability.

Gross NPAs and restructured advances remained high



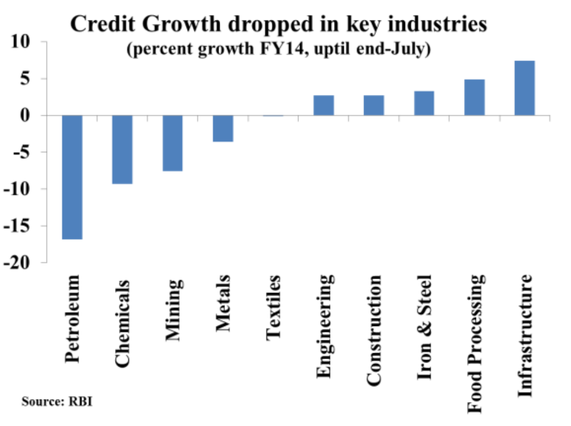
Source: Reserve Bank of India

Corporate vulnerabilities were transmitted to the banking sector, affecting asset quality. Gross non-performing assets (NPAs) of commercial banks recorded an average increase of 24.7 percent during the last six years and reached US$30 billion in FY2013. Public sector banks (which account for 73 percent of banking assets) share a disproportionate burden of this increase. While restructured advances (some of which are expected to translate into NPAs) stood at 6 percent of standard advances for all commercial banks, the figure was around 9 percent for nationalized banks at end-March 2013. NPAs saw a decline in Q4 of FY2013, owing to improved recovery, lower slippages and higher write-offs. However, this improvement was short-lived, as gross NPAs and restructured assets of scheduled commercial banks rose again, reaching around 10 percent in June 2013. The deterioration was due mainly to

[4] FX translation adjustments refer to converting the figures related to accounting stated as per one particular currency to another currency to meet the finance reporting-related requirements

slippages with the public sector banks. Latest estimates indicate that gross non-performing loans (NPLs) are expected to increase from 3.4 percent in March 2013 to possibly 4.4 percent by March 2014.

The deteriorating asset quality has exacerbated risk aversion among banks, and has likely played a role in the slowing in credit growth. Growth in total bank credits decelerated to 14.9 percent y-o-y by end-July 2013, from an average growth of 16.6 percent y-o-y during FY2012. In particular, credit growth declined significantly in industries such as petroleum, chemicals, mining and metals. Although the bank-corporate balance sheet nexus appears to be putting pressure on banks' asset quality, the RBI's proposed measures to collate large common exposures across banks are expected to contain potential issues, to a significant extent. Funding pressure on banks is likely to be minimal as deposit growth remains broadly consistent with credit growth. While the capital adequacy of banks is comfortably above the regulatory levels required, the public sector banks have large capital infusion needs. This is vital in order for them to contribute to sustaining credit growth to support an economic recovery and for weathering the current stress build up.



The worsening asset quality is also putting pressure on banks' profitability. RBI estimates reveal that loss to banks due to NPAs has amounted to more than 60 per cent of their net profit since 2010. Furthermore, yield on advances would have improved by an average of 124 basis points in the last five years, if it were not for the NPAs. Lower profits are attributed mainly to lower net interest income growth, which declined from a high of 35 percent in FY2011 to 11 percent in FY2013. A report by the ICRA indicates that the decline in profitability is due mainly to lower net interest margins, provisions for wage revisions and elevated credit costs of public sector banks, whereas profitability of private banks has remained stable. However, with a decline in 10-year government security yields between March and June 2013, net profitability is partly cushioned by sale of investments.

1.5 Fiscal developments

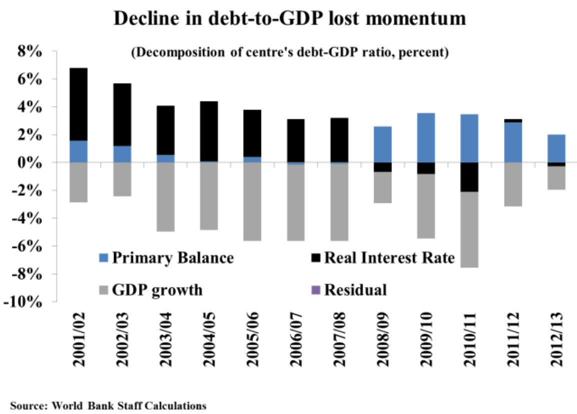
The central government's FY2013 fiscal deficit came in better than expected. Revised data show that the central government's fiscal deficit in FY2013 reached 4.9 percent of GDP, well below last October's target of 5.3 percent and better than the 5.2 percent estimate in March. Lower current expenditures and higher non-tax revenue were the main components responsible for the reduction.[5]

Despite the improved fiscal performance, the decline in the debt-to-GDP ratio has lost momentum. The central government's debt-to-GDP ratio inched up marginally to 53 percent in FY2013 from 52.9 percent in the previous year, reversing the strong downward trend seen during the second half of the 2000s.[6] Following the adoption of the Fiscal Responsibility and Budget Management Act in 2003, the ratio of central government's debt-to-GDP fell by more than 10 percentage points. This decline in the debt ratio, however, can be attributed mostly to a favorable macroeconomic environment: rapid GDP growth and, in the later period, very low real interest rates. A deceleration in growth and increase in the primary deficit slowed the decline in debt-to-GDP and the internal liabilities ratio of the central government rose for the first time in

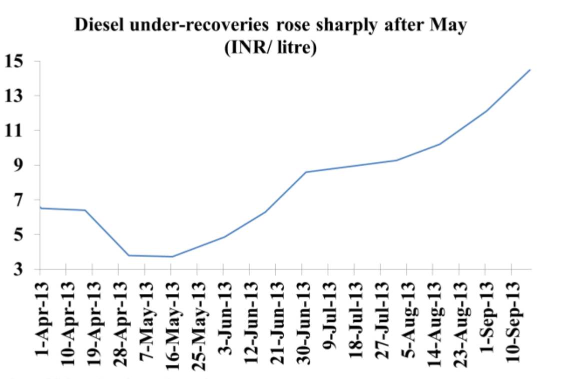
[5] Excluding one-time divestment proceeds from revenues, the overall deficit in FY2013 came down to 5.1 percent of GDP from the earlier estimate of 5.4 percent.

[6] Central government debt refers to its total liabilities which include market loans, treasury bills, borrowings from small savings, provident and reserve funds, etc., and external borrowings.

eight years from 48.3 in FY2012 to 48.6 percent in FY2013. External sovereign debt, however, declined marginally (in US$) by 0.3 percent to US$81.7 billion in FY2013.



Deficit targets have come under pressure in FY2014. According to the Controller General of Accounts, the central government incurred a fiscal deficit of 3 percent of GDP during the first four months of FY2014, equivalent to 62.8 percent of its fiscal deficit target for the year. In comparison, fiscal performance during the first four months of FY2013 was closer to target as the authorities ran a fiscal deficit of 51.5 percent of the total budget estimate during that time. A significant portion of the shortfall can be attributed to lower tax collection due to a slower pace of economic activity: the central government collected just 16.4 percent of its total budgeted tax revenue between April and July 2013, compared with 18.5 percent of budget estimates over the same period last year.

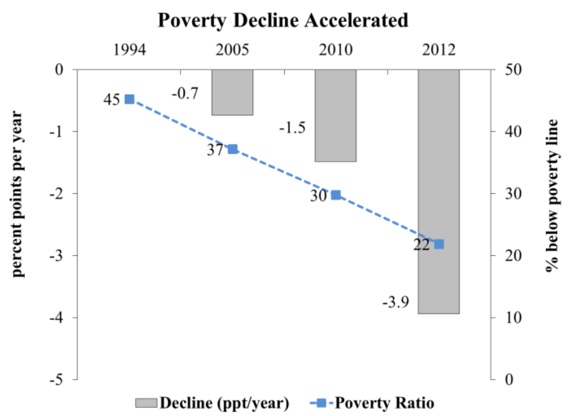


Rising fuel under-recoveries are likely to stress the budgeted subsidy bill. FY2014 budget estimates anticipated a decline in fuel subsides to Rs.650 billion or 0.6 percent of GDP from 1 percent of GDP during the previous year. Under-recoveries – the difference between international fuel prices and costs of production that arise due to regulated domestic fuel prices – were expected to decline substantially in FY2014 as the authorities introduced a cap of nine cylinders per year on the sale of subsidized LPG and a Rs.0.50 per liter monthly increase in diesel prices until losses by the oil marketing companies (OMCs) are covered. However, since May 2013, the depreciation in the rupee has sharply pushed up the under-recoveries incurred by OMCs on imported crude. Diesel under-recoveries had risen to Rs.14.50 per liter by 15th September 2013, well above the average level of Rs.11.4 per liter during FY2013. Combined OMC under-recoveries on the sale of diesel, kerosene and LPG have risen by 39.3 percent since the beginning of FY2014 to Rs.4.9 billion per day in September. As international oil prices remain high and the rupee, despite recent improvements, continues to trade well below last year's levels, the total fuel subsidy cost is likely to exceed budget estimates in the absence of further steps to link domestic and global prices.

1.6 Poverty and income distribution

The pace of decline in poverty has accelerated. Between 2005 and 2012, India lifted 137 million people out of poverty. Poverty declined by 2.2 percentage points per year, as the poverty rate (based on the national poverty line of US$1.17 (PPP) per person per day) fell sharply from 37 percent to 22 percent during this period. Compared with 1994-2005, when poverty fell at a rate of 0.7 percentage points per year, the later episode represents a significant increase in the rate of poverty reduction. At this pace, accelerated progress against poverty since economic reforms began in earnest in the early 1990s signals the emergence of a (statistically) robust new trend. Poverty decline has been widespread, with both rural and urban poverty rates falling to 26 percent and 14 percent in 2012.

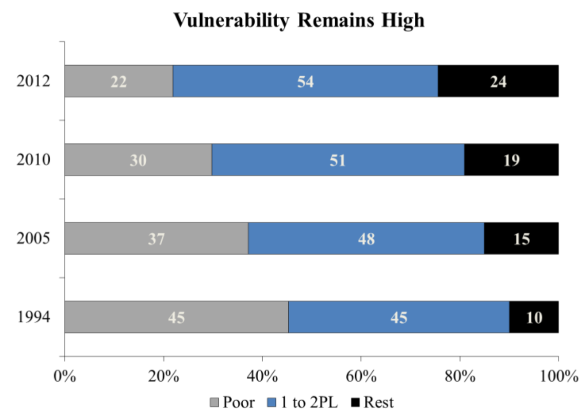
The ability of growth to drive down poverty has increased. Since 2005, alongside faster growth, a much stronger link between growth and poverty reduction is evident. Per capita income growth has picked up during the period over which poverty is measured – from 4.2 percent GDP growth in the previous decade (1994-2005) to 6.7 percent annually from 2005 to 2012. However, prior to 2005, data uncertainties clouded our assessment of whether the growth process had become more or less pro-poor in the post-reform period. Recent data suggest that the poverty elasticity to growth has risen markedly regardless of which measure of growth (in mean household consumption or growth based on the national accounts) is used.



The poorest 40 percent are increasingly sharing the benefits of growth. Although consumption growth of the poorest 40 percent continues to lag behind the India average, the gap has been closing over time. Between 1994 and 2005, per capita consumption of the bottom 40 percent grew only 61 percent as fast as that of the average Indian; between 2005 and 2012, that ratio rose to 86 percent as consumption growth rates for the poor started catching up with the mean. Although the ratio remained below one, implying that inequality has continued to increase – the Gini coefficient rose from 30.9 in 2005 to 32.3 in 2012 – the pace of the increase has slowed and the absolute widening of inequality has been small.

The geography of poverty reduction is changing towards low income states. Notably, a much larger fraction of the overall poverty reduction is now taking place in the low income states (LIS).[7] Decompositions show that whereas only a quarter of the poverty decline in the 1994 to 2005 period was due to the LIS, better performance in these states now accounts for nearly half of the decline.

Many of India's newly non-poor remain vulnerable and minor shocks could easily push them below the poverty line. Three out of every five Indians are not poor but live dangerously close to poverty (between one and two poverty lines). Considering that the current poverty line is equivalent to US$1.17 in PPP terms, individuals living below a threshold of two poverty lines remain precariously vulnerable to shocks which could push them into poverty.



1.7 Reform actions

The reform momentum has picked up in the last year with authorities putting forth a number of important reform initiatives. These reforms include a major expansion of social protection coverage with the passage of the National Food Security Act, a new Land Acquisition Bill that replaced more than 100-year-old legislation, a new Pension Bill that allows foreigners to invest in Indian pension fund companies, a Banking Laws Bill that allows for new banking licenses, a Companies Bill that replaces sixty-year old legislation and increases transparency and corporate accountability, and the raising of ceilings and/or FDI-easing reforms in a number of sectors.

[7] Low income states include Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, Rajasthan, and Uttar Pradesh.

Together with new policy announcements by the new RBI Governor and a 10-point action plan to accelerate growth by the Finance Minister, these developments send a strong signal about a recovery in reform momentum.

The National Food Security Act entitles two-thirds of the population to subsidized food grains. The National Food Security legislation was cleared by the Parliament and approved by the President in September 2013, making access to food a legal right. The Act entitles 67 percent of the country's population to five kilograms of subsidized food grains per person per month, procured and distributed through the existing Targeted Public Distribution System (TPDS). Central issue prices of rice, wheat, and coarse grains have been fixed at Rs.3, Rs.2 and Rs.1 for the next three years, against the economic cost of Rs.23.5 and Rs.18 for rice and wheat in FY2013 according to estimates by the Food Corporation of India (FCI). Comparing current TPDS usage (as reported by households in the 2011-12 round of the National Sample Survey) with the Act targets suggests that the take-up of the system may rise by one and a half times in rural areas and nearly two times in urban areas, while food purchase prices could decline by about half for an average below-poverty-line (BPL) household. On the other hand, a shift from household to individual entitlements could reduce the endowment of an average BPL family of five from 35 kg to 25 kg. Implementation of the Act over the course of a full fiscal year is expected to raise the food subsidy bill to 1.1 percent of GDP from an average of 0.8 percent of GDP in FY2012-13.[8] However, the fiscal impact in FY2014 is likely to be limited as the Act was passed in the middle of the year and entails certain follow up action in various states; furthermore, the FY014 budget already included an additional allocation of Rs.100 billion for the incremental costs of the Act in FY2014. In addition to these costs, further expenditures will be incurred by the states and the central government to set up grievance redress offices and State Food Commissions. However, provisions to reform the TPDS by introducing doorstep delivery of food grains, end-to-end computerization, identification of beneficiaries using the Aadhar number, and cash transfers, food coupons, or other schemes for targeted beneficiaries in lieu of food grains could improve efficiency and reduce costs over the long term.

The new Land Acquisition Bill proposes to reduce uncertainty and address structural constraints to growth. Replacing the Land Acquisition Act of 1894, a new Land Acquisition, Rehabilitation, and Resettlement Bill was passed by the Parliament in September 2013. The Bill proposes to reduce uncertainty in land acquisitions by outlining clear guidelines on the process of acquiring land and fair compensation to those displaced. At the same time, however, instances when several rounds of impact assessments and evaluations might be required could prolong the acquisition process.

The Pension Bill allows foreigners to invest in Indian pension fund companies. The Pension Fund Regulatory and Development Authority (PFRDA) Bill was passed by the Parliament in September 2013, nearly a decade after the New Pension System – now rechristened the National Pension System (NPS) – was implemented in 2004. The Bill grants statutory status to the PFRDA – which was established through an ordinance in 2003 – and the presence of a statutory regulatory authority is expected to help enhance the quality of products and services available in the pension sector. The NPS, which is mandatory for all central government employees and voluntary for all other employed citizens, is based on a pay-as-you-go principle. The Bill amends the existing system by allowing up to 26 percent foreign investment in the pension sector (which could rise to 49 percent, in line with the insurance threshold), thereby widening the potential set of available pension products, schemes, and fund managers. The Bill also lays down rules that would allow foreign companies to invest in reinsurance companies.

[8] These estimates are based on calculations by the Ministry of Consumer Affairs, Food and Public Distribution and they assume full coverage and no leakages.

The amended Banking Laws Bill paves the way for new bank licenses. The Banking Laws (Amendment) Bill 2011 was passed in December 2012 by both Houses of Parliament. The Bill strengthens the regulatory powers of the RBI and paves the way for new bank licenses, leading to the opening of new banks and branches. It also enables nationalized banks to raise capital by issue of preference shares or rights issue or issue of bonus shares. Banks can now increase or decrease the authorized capital with approval of the Government and the RBI, without being limited by Rs.30 billion ceiling.

The new Companies Act increases transparency and corporate accountability. The Companies Bill became a law in August 2013, replacing a six-decade old Act. The Bill seeks to bring sweeping changes in transparency and accountability of companies, encourages self-regulation and makes contribution towards Corporate Social Responsibility mandatory, among other things.

The new RBI Governor proposed several reforms to liberalize financial markets and facilitate financial inclusion. The Governor, who was appointed in September, announced a comprehensive financial reform agenda on the day of his induction. First, opening of new bank branches would no longer require RBI approval, subject to certain conditions. The RBI will also gradually reduce the current requirements for banks to invest in government securities. Second, to facilitate the inflow of non-resident deposits, Indian banks will be allowed to swap forex liabilities against FCNR(B) (Foreign Currency Non-Resident, Bank) deposits at a fixed cost of 3.5 percent per annum, compared to market rates of around 6-8 percent. In addition, the current overseas borrowing limit of 50 per cent of the unimpaired Tier I capital will be raised to 100 per cent and borrowings mobilized under this provision can be swapped with the RBI at a concessional rate. Third, to encourage household savings in financial instruments, the RBI proposed to introduce Inflation Indexed Savings Certificates linked to the new consumer price index by November 2013. Furthermore, in the spirit of financial inclusion, proposals for “mini-ATMs”, point-of-sale terminals by non-bank entities, a new online national bill payment system and mobile payments, were also announced. Finally, new expert committees were proposed to look at the monetary policy framework, screen bank license applicants and restructuring and recovery processes of banks.

The authorities reaffirmed their plan for capital infusion to public sector banks to ease balance sheet stresses. A Rs.140 billion capitalization plan for public sector banks was announced earlier this year. The capital infusion will be vital to help the stressed public sector banks meet Tier 1 capital requirement. A similar capitalization effort in 2009 helped the banks sustain credit growth in the post-global financial crisis period, and thereby, contribute to a faster economic recovery from the crisis.

The authorities took further steps to ease policies regulating foreign direct investment. In September 2012, the government raised caps on FDI in several sectors such as multi and single brand retail, aviation, broadcasting and power exchanges in order to attract robust capital inflows. However, the decision to allow FDI in multi-brand retail carried several caveats, such as prior state approval and procurement and investment requirements, and no foreign multi-brand retailers has yet taken advantage of the new rules to enter the Indian market. In September 2013, the authorities took further steps to ease the investment and procurement requirements. In addition, the Government recently raised the FDI limit in telecom to 100 percent, defense to 26 percent (on a case-by-case basis), and put several sectors on an automatic route which allows firms to invest without prior government approval.

2. Outlook

The economy is likely to expand by 4.7 percent in the current fiscal year. The expected outturn would bring growth to its lowest point since FY2003, when real GDP increased by 3.9 percent. The pace of economic activity in FY2014 will be hampered by a weak outturn during the first quarter; furthermore, two consecutive months (July-August) of negative business sentiment and higher interest rates are likely to limit the potential for recovery in Q2 FY2014 despite a strong rebound in manufacturing output in July. However, as financial markets stabilize, exporters continue to take advantage of improvements in external competitiveness following the depreciation bout in the rupee, recovery in the manufacturing sector continues, and delayed investment projects begin to come on stream, activity is expected to pick up strongly in the last six months of the fiscal year, rising above 6.0 percent saar in Q4 FY2014. The recovery will also be supported by a pick-up in agricultural activity due to heavy and early monsoon rains which – while damaging some crops like coffee – have resulted in higher summer planting of rice, corn, barley, cotton, and soybeans. This is expected to result in a bumper summer crop as well as improved agricultural output in winter due to higher soil moisture levels.

Growth is expected to accelerate further in FY2015. The anticipated pick-up in activity in the second half of FY2014 is expected to carry over into the next fiscal year, with quarterly growth accelerating to around 6.5 percent saar in the second half of FY2015. As a result, real GDP growth is expected to reach 6.2 percent in FY2015. On the one hand, continued high oil prices – expected to average just above US$100/barrel in calendar 2013 and just below that level in 2014 – are likely to somewhat dampen the recovery potential. On the other hand, strengthening performance in the US and Europe – India's major export markets – is expected to support the growth momentum. Domestically, the recovery will need to be buttressed by stronger investment, which is expected to return to levels above 30 percent of GDP in FY2015 after falling below this threshold in FY2013.

Inflationary pressures are likely to moderate further. The downward momentum in core WPI inflation, observed throughout calendar 2013, is expected to continue in FY2014. Six consecutive quarters of sub-6 percent growth have allowed for an opening of the output gap, which is likely to limit inflationary pressures even with the expected acceleration in economic activity during the forecast period. Food prices, which have pushed inflation in the current calendar year, are also expected to moderate as agricultural output improves. Fuel prices, on the other hand, will continue to add to the inflationary momentum as international oil prices are likely to remain elevated throughout the forecast period. Altogether, WPI inflation is expected to average 5.3 percent in the current fiscal year and decelerate further to 5.2 percent in FY2015 as pressure from food prices declines due to an improvement in agricultural output.

The current account deficit is expected to narrow. The first quarter of FY2014 witnessed a widening of the trade deficit as the depreciation in the rupee and inelastic demand for imported oil – which accounts for more than one-third of total merchandise imports – have kept imports elevated while the exports response was subdued. Exports, however, rebounded strongly in July and August while imports came down, and a continuation of these trends is expected to bring down the trade deficit in the coming quarters. Although exports are expected to rise overall, export response in the manufacturing sector could be somewhat muted by rising costs of imported intermediate inputs, especially as metal prices are expected to remain elevated throughout the forecast period. Similarly, while the summer bout of depreciation in the rupee is likely to dampen demand for imports, scope for import compression is limited by a high (45 percent) share of fuel and raw material imports in total. These factors suggest that while the trade deficit is likely to narrow in FY2014, the improvement will be gradual. Beyond the trade deficit, improving labor market conditions in the US could further support the current account balance via stronger remittances: the US generates nearly one-third of total remittance inflows into India and the recovery in US migrant employment has been much stronger than for native workers. The combination of these trends is likely to result in the current account deficit narrowing to 4.1 percent of GDP in FY2014 and improving further to 3.7 percent of GDP in FY2015.

Financing of the current account deficit is unlikely to present major challenges. In FY2014, the financing mix is expected to be similar to the average performance of the last few years: FDI is expected to improve marginally from FY2013 (a down year) while FII would come down somewhat from the highs of last fiscal. As long as NRI deposits – which mainly represent savings for future spending in India – remain similar to last year and under varying assumptions about the availability of trade credits, the remaining FY2014 external financing requirements would range between US$3-10 billion, which ought to be relatively comfortably financed via foreign borrowing. International reserves could decline somewhat in FY2014 but would still amount to a comfortable import cover of approximately five months.

Achievement of fiscal targets is likely to require further expenditure restraint. A repeat of better-than-expected FY2013 fiscal performance by the central government is likely to be more challenging in FY2014 as the headroom gained through diesel subsidy reform thus far has been wiped out by the depreciation in the rupee. In addition, the roll-out of the National Food Security Bill is expected to raise expenditure by an additional 0.1 percent of GDP relative to the budgeted PDS allocation, although the full effect of implementing the act will not be felt in FY2014. The authorities are likely to realize some savings from the continued widening of Direct Benefit Transfer schemes in scope and district coverage. However, some of the larger gains, such as efficiency improvements from direct transfers of LPG subsidies into Aadhar-linked bank accounts of beneficiaries, are likely to start materializing only towards the end of FY2014. As the scope for improved tax collection is likely to be limited given the subdued pace of activity in the first half of FY2014, expenditure restraint – particularly further progress to contain the fuel subsidy bill – will be key to maintaining good fiscal performance. Under these assumptions, the general government deficit is likely to rise somewhat to 7.3 percent of GDP in FY2014 before declining to 7.1 percent of GDP in FY2015. Pressure on deficit targets could rise further if the central government's divestment proceeds – which are included above-the-line under the national accounting practices and are expected to generate revenues of 0.6 percent of GDP in FY2014 – were to come in below expectations.

The debt-to-GDP ratio could rise for a second year in a row, but is expected to resume a downward path in the medium term. Most of the decline in the debt-to-GDP ratio over the past decade can be attributed to a favorable macroeconomic environment and particularly rapid GDP growth. As growth slowed markedly in FY2013, the general government debt-to-GDP ratio is estimated to have risen by one percentage point to 68.7 percent of GDP. Under the growth, inflation, and fiscal deficit scenario delineated in the previous discussion, the debt-to-GDP ratio is likely to rise further in FY2014, reaching 71 percent of GDP. Thereafter, under the assumption that growth accelerates, the central government continues its fiscal consolidation efforts, and state governments remain on the adjustment path recommended by the 13th Finance Commission (see Box 1), the debt-to-GDP ratio is expected to resume its earlier downward trend, albeit at a slower pace than before. Even if real interest rates rise, a recovery in growth and continued commitment to fiscal discipline are expected to offset any potential adverse effects on debt sustainability. On the other hand, risks to improvements in the primary balance or growth recovery could have substantial negative implications for the debt-to-GDP trajectory: if economic growth were to fall below the baseline projections in each of forecasting years by one standard deviation of the historical distribution, the general government's debt-to-GDP ratio could rise to nearly 76 percent of GDP by FY2016.

The largely positive near- and medium-term outlook is conditional on continued improvements in the policy environment and is subject to important downside risks. The current macroeconomic environment of a trough in growth and rising external vulnerabilities offers a window of opportunity for the authorities to strengthen the foundations for higher long-term growth. The baseline scenario of acceleration in growth in the second half of

Box 1: Fiscal Consolidation and the 13th Finance Commission Fiscal Performance Targets

Although fiscal deficits at all levels of government have been on the decline for the past two years, only the state governments have been able to meet the fiscal consolidation targets of the 13th Finance Commission (FC), a constitutional body tasked with making recommendations on resource transfers between different levels of government and setting targets for fiscal sustainability. According to the targets laid out in a 2009 report by the 13th FC, both the central and general government are off track with regard to fiscal deficit goals. However, both levels of government were able to achieve the debt/GDP targets set by the 13th FC, partly because of a revision in the national accounts series in 2010 which increased the level of the denominator (GDP) by approximately 3 percent

Consolidated Fiscal Reform Path of the General Government

(all figures in percent of GDP)			2009-10	2010-11	2011-12	2012-13 est	2013-14f	2014-15f
Fiscal Deficit	State Governments	13th FC target	2.8	2.6	2.5	2.5	2.4	2.4
		Actual / Projected	2.9	2.9	2.3	..	..	..
	Central Government	13th FC target	6.8	5.7	4.8	4.2	3.0	3.0
		Actual / Projected	6.5	4.8	5.7	4.9	..	..
	General Government	13th FC target	9.5	8.3	7.3	6.7	5.4	5.4
		Actual / Projected	9.4	7.6	8.1	7.0	7.3	7.1
Outstanding Debt Stock	State Governments	13th FC target	27.1	26.6	26.1	25.5	24.8	24.3
		Actual / Projected	25.5	23.2	22.4	..	..	..
	Central Government	13th FC target	54.2	53.9	52.5	50.5	47.5	44.8
		Actual / Projected*	50.1	46.6	47.2	48.1	..	..
	General Government	13th FC target	78.8	78.3	76.6	74.3	70.8	67.8
		Actual / Projected	73.3	67.9	67.9	68.7	70.8	70.5

* Note: The central government's outstanding debt stock has been adjusted to match the definition used by the 13th FC which excludes the special securities issued by State Governments to NSSF. This figure is included in the Centre's public accounts and in our own calculations of Centre's debt, however we deduct it from general government debt to avoid double-counting.

Despite lagging behind the FC fiscal adjustment targets, central and general government deficits remain on a sustainable path thus far. One way to assess fiscal sustainability is with a model-based approach, which determines whether the government systematically responds to an increase in government debt by reducing primary deficits so as to prevent the debt path from becoming explosive. Bohn (1998, 2005) showed that in a regression of the primary deficit on public debt, the cyclical position of the economy, and the transitory component of government spending, a negative regression coefficient on the debt variable is sufficient to establish that fiscal policy is responsible. Analysis using state and central government data between FY1991 and FY2012 shows a negative, highly statistically significant relationship between general and central governments' primary deficit and debt-GDP ratio, while results for state governments are correctly signed but not statistically significant. These results are robust to various ways for correcting for serial correlation, and the data do not exhibit strong evidence of non-stationarity.

Dependent variable: primary budget deficit (percent of GDP)

	General Government			Central Government			State Government		
	OLS	Newey-West	Prais-Winsten	OLS	Newey-West	Prais-Winsten	OLS	Newey-West	Prais-Winsten
Lagged government debt, percent of GDP	**-0.253*****	**-0.253*****	**-0.230*****	**-0.154****	**-0.154****	**-0.139****	**-0.0464**	**-0.0464**	**-0.0520**
	(0.0486)	(0.0373)	(0.0560)	(0.0554)	(0.0723)	(0.0583)	(0.0282)	(0.0375)	(0.0561)
Cyclical component of government spending, percent of trend GDP	1.509***	1.509***	1.422***	0.708*	0.708	0.764**	0.776*	0.776*	0.445
	(0.304)	(0.294)	(0.323)	(0.389)	(0.489)	(0.298)	(0.417)	(0.393)	(0.301)
Cyclical component of GDP, percent of trend GDP	-0.322***	-0.322***	-0.273**	0.0447	0.0447	-0.0107	-0.428***	-0.428***	-0.404**
	(0.102)	(0.0817)	(0.0982)	(0.0910)	(0.105)	(0.0726)	(0.141)	(0.114)	(0.141)
Observations	21	21	21	21	21	21	21	21	21
R-squared	0.805	0.805	0.735	0.462	0.462	0.501	0.394	0.394	0.240

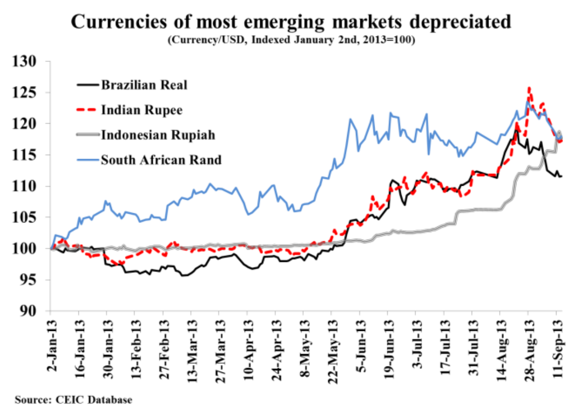
Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

FY2014 and further improvements thereafter builds in the assumptions of continued progress on the policy reform agenda as well as a benign global environment. Steps taken by the authorities to clear the pipeline of stalled and shelved investment projects – e.g., by setting up the Cabinet Committee on Investment in December 2012 and, more recently, a special project-monitoring group which removed last-mile hurdles to 28 large infrastructure investment projects worth just over 1 percent of GDP – will need to be followed up with additional actions and close monitoring of delays in project preparation to ensure that the rebound in investment envisioned in the forecast materializes. A set of banking sector reform measures announced by the new RBI Governor are likely to improve flexibility in the banking system and facilitate financial inclusion and penetration through expansion of point-of-sale terminals and mini-ATM usage. However, growing vulnerabilities in the corporate and banking sector must be watched closely, as the baseline scenario assumes no further substantial deterioration in asset quality.

Although the depreciation of the rupee has boosted the competitiveness of Indian exporters, many other emerging economies have also seen their currencies weaken against the dollar. Lasting, substantial improvements in export competitiveness will require policy efforts to narrow the infrastructure gap and ease the restrictive regulatory environment which creates strong incentives for Indian firms to remain small (see Box 2). While the authorities have made important progress on fiscal consolidation, the positive fiscal and debt sustainability outlook in the baseline scenario is conditional on further steps to reduce distortions and lower subsidy costs, particularly the under-recoveries on diesel. Furthermore, expenditure restraint alone is unlikely to be a solution given the large infrastructure and social protection needs. In this regard, progress on the long-delayed Goods and Services Tax (GST) agenda – which could improve domestic market integration, reduce cascading tax inefficiencies, and boost revenue collection in the long term – is particularly important to long-run fiscal sustainability and high growth.

3. Depreciation of the Rupee

The Indian rupee fell to historic lows in August 2013 before staging a recovery in September. Since the beginning of May 2013, the currency lost more than 20 percent in value against the US dollar. After stabilizing around Rs.54 per US dollar during the first five months of 2013, the rupee fell to a record low of Rs.68.4 on August 28, 2013, as portfolio investors withdrew a combined US$13 billion from Indian equity and debt markets in June-August 2013. In September, however – buoyed by a series of positive news including the Federal Reserve's decision to continue the asset purchasing program, the appointment of a new RBI Governor, and improved export performance – the rupee recovered about a third of its recent losses and retreated to the Rs.62/US$ range.



The depreciation in the rupee closely followed movements in other emerging market currencies. Foreign investors have been withdrawing resources from emerging markets on fears that the US Federal Reserve Quantitative Easing (QE) program may be pulled back quicker than expected. In this regard, weaker-than-expected US job creation in August and a downward revision to July employment numbers have supported markets by adding to the sentiment that the Fed's 'tapering' may be postponed. The portfolio reallocation spurred by fears of 'tapering' has pushed down the values of a number of currencies across the globe, including the South African rand, the Brazilian real, and the Indonesian rupiah. Movements in these currencies – and in particular the Indian rupee – mirror closely the movement of yields on 10-year US Treasury bonds.

Only about two-thirds of the depreciation bout can be explained by underlying fundamentals. An econometric model which considers short-term financial market dynamics around a long-term cointegrating relationship between the nominal exchange rate, relative prices, and gold prices, fits the behavior of the rupee-US dollar exchange rate quite well over the past five years. However, the model's ability to track exchange rate movements during the most recent depreciation bout is much weaker,

Box 2: Facilitating Growth of Small Businesses‡

Indian firms operate within a complex web of laws, rules, and inspections that interact with a vast array of incentives. These may hold back firms from operating on a level playing field and at appropriate scales in unified domestic markets and abroad. In particular, firms in India face specific challenges in the areas of insolvency, inspections & compliance, labor, and land acquisition.

Insolvency: Smaller enterprises in India are overwhelmingly single proprietorships or partnerships, subject to largely outdated personal bankruptcy laws – Provisional Insolvency Act (1920), Presidency Towns Insolvency Act (1908), and Sick Industrial Companies Act (1965) – that make it virtually impossible for entrepreneurs to restructure and work towards solvency. Moreover, several criminal statutes apply to events that typically occur during periods of financial stress, such as late payments of statutory liabilities. As a result, entrepreneurs do not have access to adequate stay, discharge, and rehabilitation mechanisms, and liquidation proceedings can take two to ten years.

Inspections & compliance: Operational compliances are required individually for almost all the steps in running firms, with the central government providing the overall legal framework and state governments formulating and implementing the specific regulations. A basic set of compliances for a small manufacturing firm would consist of 8-10 central and an additional 15-20 state and municipal clearances. As a result, compliance costs are high, delays are endemic and prolonged, and there is a high level of inspections which requires management time that could be used productively in running the firm. Multiple regulations have separate inspection regimes, creating incentives for firms to remain small or risk becoming subject to repeated and unpredictable visits.

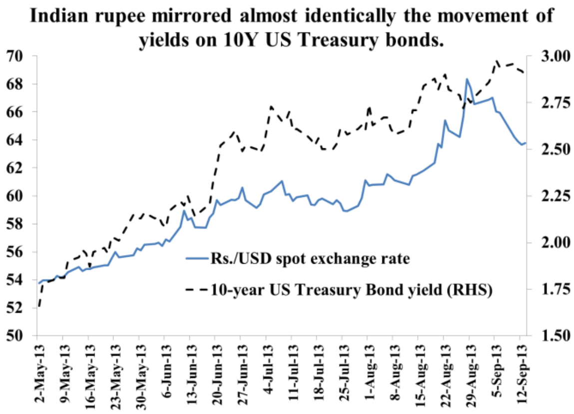
Labor: Labor regulations are widely recognized by both firms and analysts to be a constraint on the growth of formal employment as well as a factor in the expansion in use of contract labor as a regulatory avoidance strategy. While relatively few firms are subject to the provisions of the Industrial Disputes Act (1947), the interaction of the compliance and reporting requirements of the Factories Act (1948) with the penalties to growing past size limits defined in the benefits packages under the MSME Act (2006), create a powerful impetus for firms to stay small to avoid highly burdensome hiring and firing rules.

Land: As the operation of land markets is a concurrent responsibility of the central and state governments in India's federal structure, there is a mass of complex derivative and subordinate regulation in this area. For many small firms, the two key stress points regarding land relate to very significant procedural delays due to substantial variations among localities in the interpretation of existing laws, and the chronic shortage and high price of industrial land, especially in urban areas. Time-consuming procedures for the registration of real property, transfer of titles, disputes related to base rates for property valuation and taxation and obtaining construction permits add to time and money compliance costs for small firms.

A number of states have taken steps to ease these burdens, creating a mosaic of 'best-practice' examples across states in different areas. Some have simplified tax administration processes, including the introduction of e-filing and e-returns. Others have established joint inspections by various departments, easing the administrative burden on firms. Other states having simplified labor registers across Acts to maintain a common/single labor register to store all records. With regards to land, some states have taken steps to reduce the time taken to grant land conversion or to allot land in industrial estates, in some cases to less than 30 days.

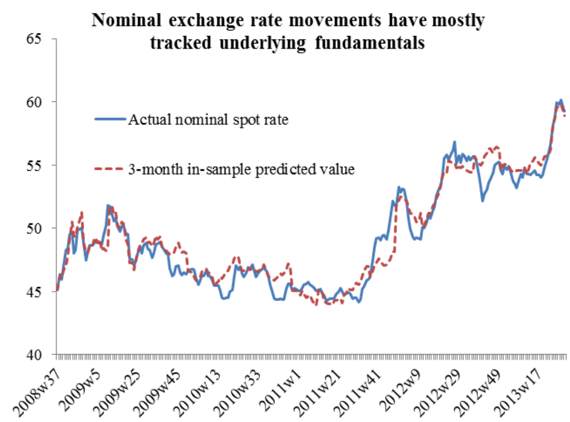
‡ *This box summarizes some of the findings of a background note "Regulations Restricting the Growth of Non-Farm Enterprises" by Deepak Bhattasali, Luke Simon Jordan, and Neeti Katoch.*

explaining only two-thirds of the observed variation. This suggests that expectational factors, driven chiefly by the tapering concerns, seem to have created greater volatility than would normally be expected. At the same time, however, many of the semi-structural factors underpinning the depreciation (relative price and interest rate differentials, central bank balance sheet size, etc.) remain prevalent and may require further attention by the authorities.



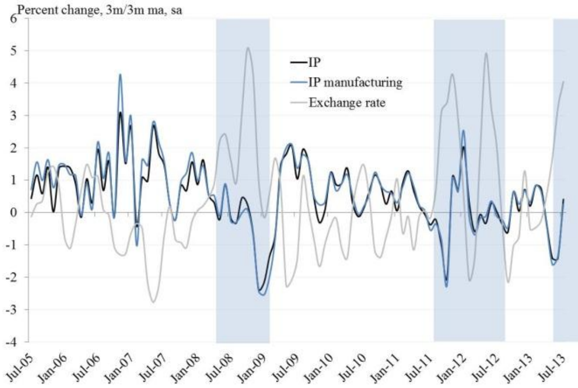
The initial response by the authorities could not allay market fears. While the monetary tightening in July propped up short-term interest rates, it also increased borrowing costs and added further stress to the corporate and banking sector profitability. Steps to attract additional foreign investment in August – through issuance of quasi-sovereign dollar denominated bonds and liberalization of external commercial borrowings and non-resident deposit schemes – were announced at the same time as restrictions on capital flows out of India, including overseas direct investment, outward remittances, and purchase of immovable property. Increases to import duties on gold and electronic items have curbed (official) imports but are unlikely to be a long-term solution. The authorities also reduced minimum land requirements for special economic zones (SEZ) and announced new export promotion schemes, but these measures are likely to be less effective than some of the deeper competitiveness reforms which could significantly increase export potential.

Since then, the authorities have shifted attention to longer-term solutions. As the authorities became aware that earlier actions had not buttressed investor confidence, the focus shifted towards a more strategic communication with a longer-term perspective. Announcements by the Finance Minister and the new RBI Governor have focused on the need for structural reforms to accelerate growth and reduce macroeconomic vulnerabilities. Policy actions by the RBI have focused on improving banking sector flexibility and making it easier for exporters and banks to access foreign exchange. The markets have reacted favorably to these recent developments as the rupee recovered and equity markets rebounded sharply in September, even prior to the Fed's calming announcement at the end of the month.



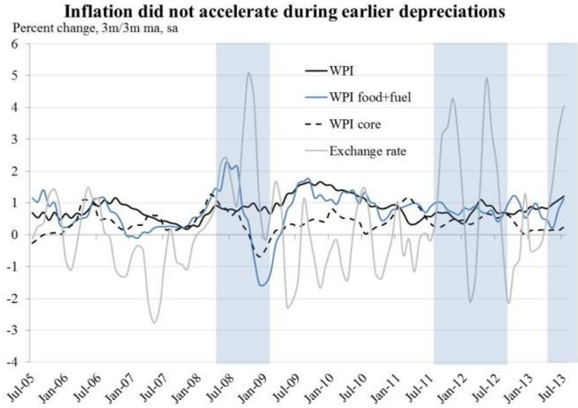
Depreciation episodes in recent history have not been accompanied by large shocks to price or output growth. India's recent history provides some clues on the potential impact of the rupee depreciation on economic activity. In late 2008 the rupee fell from around Rs.40 to Rs.50 per US$ (later recovering to around Rs.45), and in late 2011-early 2012 it dropped from around Rs.45 to Rs.55. Both episodes coincided with substantial global uncertainty: the global financial crisis and the euro-zone crisis. Therefore, any deceleration in economic activity could be equally attributed to slowing of partner country growth as to the direct impacts of the exchange rate movements on output. However, what is remarkable is that none of the two episodes was characterized by a dramatic change in the main economic trends. If anything, inflation appears to have slowed in line with the decelerating pace of activity. With regard to trade, it is difficult to identify a clear pattern in export performance during the previous episodes, although imports decelerated substantially both times. However, this pattern could be a reflection of a slowdown in global trade flows as much as developments caused by currency movements.

Earlier depreciations were not accompanied by major slowdown in output



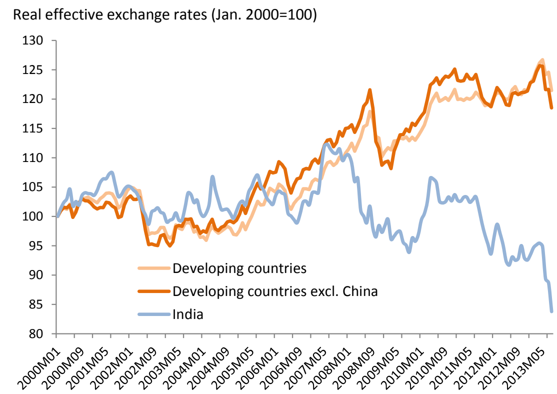
The corporate and banking sector is likely to feel substantial adverse effects of the recent depreciation. A larger number of corporates are hedged either explicitly or implicitly (through import-parity pricing). Nonetheless, in instances where companies have not properly hedged or are unable to perfectly pass through the rising costs of imports, depreciation is likely to reduce corporate profitability and could lead to a growing share of non-performing loans (NPLs). A slowing economy, high corporate leverage, lower corporate profitability, and problems in sectors with delayed investment projects were already posing significant challenges to banks. Further pressure on NPLs could exacerbate problems but is unlikely to put overall health of the banking sector at risk.

Inflation did not accelerate during earlier depreciations



While vulnerabilities in the financial sector rose, nominal depreciation also fostered an improvement in external competitiveness. Following movements in the nominal exchange rate, India's real effective exchange rate (REER) depreciated by 12 percent this calendar year. However, unlike many other developing countries, the recent depreciation comes on the back of previous REER movements which had already resulted in the REER being below its long-term average prior to the May-August nominal depreciation. As a result, India's competitiveness has received a substantial boost due to recent exchange rate movements.

India's real exchange rate depreciation has outpaced the developing country average



Exports and the trade balance are likely to benefit. Imports have substantially risen in importance in the Indian economy, increasing from just over 13 percent of GDP at the beginning of the 2000s to over 31.5 percent of GDP last year as globalization, rising incomes, and growing demand for fuel have driven demand for imported goods. Exports growth has not kept pace with imports and, consequently, the trade deficit has gradually widened from less than 1 percent of GDP in 2000-01 to 7.1 percent of GDP last year. The depreciation of the rupee, however, has helped compress the trade deficit to US$10.9 billion in August, a 23 percent reduction from last year. It is often argued that India's export response is muted, partly because primary products and especially refined petroleum account for roughly one quarter of total sales abroad and partly because manufacturing exports have a strong import component. However, empirical studies show that the exports of modern services – which account for nearly a third of total exports – are highly elastic to exchange rate depreciation. As the export response ramps up further, the goods and services trade balance is likely to continue to improve.

Impacts on overall external sustainability are likely to be minor. Short-term external debt has been on the rise, with the largest share of that debt held by the private sector. Potential difficulties in rolling over this debt may represent a substantial vulnerability to those corporates and importers who have not adequately hedged their borrowings or trade credits. On the other hand, to the extent that importers find it difficult to access short-term trade credits (US$87 billion at end-March 2013), imports would likely decline and financing needs would be smaller. Furthermore, the next largest component of external debt due to mature in the current fiscal year (US$49 billion) is deposits by NRIs, which have been rising over time and – given that much of these represent savings for future spending in India – are likely to be rolled over into new deposits, especially as interest rates have been on the rise. Financing needs could be brought down further if the strengthening dollar and improving growth in the US incentivize higher worker remittance inflows, which last year amounted to US$30 billion or 1.6 percent of GDP (around 30 percent of remittances come from the US and another 20 percent from Europe).

Pressure on fiscal balances is likely to rise but financing needs should be met adequately. The rupee depreciation would impact government balances directly through higher costs of subsidies and indirectly through the pressure on interest rates. Last year, the central government's subsidy bill rose to 2.5 percent of GDP, of which 1.1 percent was spent on imported fuel and fertilizer (0.97 percent fuel and 0.15 percent fertilizer). Despite steps taken by the authorities to liberalize diesel prices, under-recoveries have now surpassed pre-reform levels and, instead of declining to 0.6 percent of GDP as envisioned in the budget, fuel subsidies are likely to rise without additional reform steps. Beyond subsidy costs, impact of the depreciation on current expenditure through higher interest rates is likely to be limited. Total central government debt is 53 percent of GDP and interest payments amount to 3.2 percent of GDP. External debt is relatively small and largely bilateral/multilateral with low interest rates, while domestically, the central government paid approximately 8 percent on its bonds in auctions of the last two months (near-zero real rates). Total central government debt maturing in the current fiscal year amounts to 1.1 percent of GDP (Rs.840 billion of domestic debt and US$5.6 billion in external debt), but the vast majority of the domestic debt (Rs.680 billion) has already been paid back or rolled over. Therefore, total financing needs are likely to be relatively low and could be comfortably financed at a range of plausible interest rate assumptions.

Inflation could accelerate somewhat but overall pass-through will be limited. Although retail inflation eased marginally in August, it remains high at above 9 percent and further shocks to the prices of pulses (lentils) and vegetable oils – which account for 7 percent of the CPI consumption basket – could push retail inflation into double-digits. However, price increases of fuel and transportation – which account for much higher 17 percent of the CPI basket – are likely to be limited as long as the authorities maintain the current practice of allowing Rs.0.50/month increases in the price of diesel.

Some household budgets will come under stress but the overall impact on poverty is likely to be muted. Higher prices of pulses and edible oils – which account for 7 percent of household spending in rural areas – and transportation – which accounts for 4 percent of household expenditure in rural areas and 6 percent in urban – could put pressure on household budgets, particularly those of the poor and vulnerable. While labor earnings may suffer if the pace of economic activity remains muted, job losses are unlikely to be sizeable as unemployment rates are very low on account of lack of broad-based social safety nets and low female labor force participation. Both the decline in labor earnings and the increase in household expenditure in rural areas could be compensated by a good monsoon, although there could be a substantial diversity of outcomes across groups. Furthermore, some of the sectors most likely to benefit from the depreciation – e.g., agriculture and textile – are labor-intensive, which may cushion the adverse effects of weak economic activity on wages. Households that purchase gold could be worse off, but they amount to just 2.6 percent of rural households and 4.1 percent of urban households and are also likely to see the value of their existing gold holdings increase.

Economic growth is likely to be supported by continued positive export response, but could be hurt if the availability of foreign investment declines further. The overall impact of the depreciation on economic growth will be a balance between positive contributions from greater export revenues and the negative impacts of higher costs of intermediate inputs as well as reduced availability of foreign investment inflows. A weaker rupee could make it more difficult for firms to purchase imported inputs (among which capital goods are a very important component) and to access foreign financing (as the depreciation is being driven by capital outflows. As a result, there could be further downward pressure on investment growth – which has already fallen to -1.2 percent y-o-y (-11 percent saar) in Q1 FY2014 from double-digit growth recorded in earlier years – although the extent of this pressure is likely to be limited by the fact that most investment in India is financed through domestic savings, which have averaged more than 33 percent of GDP between FY2005 and FY2012.

Rupee depreciation has highlighted India's growing macroeconomic vulnerabilities but offers a window of opportunity to improve competitiveness and accelerate growth. Amidst the withdrawal of funds from emerging markets, global investors have focused more intensely on large emerging economies with greater current account and fiscal deficits. In this risk-averse environment, India's large twin deficits and slowing growth momentum have added to investors' fears. While the sentiment did improve in the first half of September, the underlying vulnerabilities remain, underscoring the importance of prudent macroeconomic policies and continued progress on the reform agenda to set strong foundations for accelerated growth in the future.

India: Selected Economic Indicators

	2008/09	2009/10	2010/11	2011/12	2012/13 Est.	2013/14 Proj.	2014/15 Proj.
Real Income and Prices (% change)							
Real GDP (at factor cost)	6.7	8.6	9.3	6.2	5.0	4.7	6.2
Agriculture	0.1	0.8	7.9	3.6	1.9	3.4	2.0
Industry	4.4	9.2	9.2	3.5	2.1	1.0	5.2
Of which : Manufacturing	4.3	11.3	9.7	2.7	1.0	0.2	4.4
Services	10.0	10.5	9.8	8.2	7.1	6.7	7.6
Real GDP (at market prices)	3.9	8.5	10.5	6.3	3.2	4.0	6.7
Prices (average)							
Wholesale Price Index	8.1	3.8	9.6	8.9	7.4	5.3	5.2
Consumer Price Index	9.1	12.4	10.4	8.4	10.4	…	…
GDP Deflator	8.7	6.1	8.9	8.3	8.2	5.3	5.2
Consumption, Investment and Savings (% of GDP)							
Consumption 1/	70.8	70.9	69.5	73.7	74.6	74.4	72.7
Public	10.9	11.9	11.4	11.6	11.8	12.2	12.2
Private	59.9	59.0	58.0	62.1	62.7	62.3	60.5
Investment 2/	32.3	31.7	31.7	30.6	29.6	29.6	30.7
External Sector							
Total Exports (% change in current US)	15.0	-5.8	37.5	17.9	0.3	15.7	21.9
Goods	13.7	-3.6	37.5	23.6	-1.1	17.1	23.7
Services	17.3	-9.7	37.5	7.1	3.4	12.9	18.3
Total Imports (% change in current US)	16.6	-0.1	28.8	24.2	1.1	7.8	18.2
Goods	19.8	-2.6	26.7	31.1	0.5	8.8	19.5
Services	1.1	14.4	39.4	-7.3	5.0	1.8	9.5
Current Account Balance (% of GDP)	-2.3	-2.8	-2.7	-4.2	-4.8	-4.1	-3.7
Foreign Investment (US billion)	8.3	47.0	37.6	38.6	46.5	41.6	47.5
Direct Investment, net	22.4	18.0	9.4	22.1	19.8	20.0	26.5
Portfolio Investment, net	-14.0	29.1	28.2	16.6	26.7	21.6	21.0
Foreign Exchange Reserves (US billion) 3/	241.4	254.7	274.3	260.1	259.7	257.2	263.2
General Government Finances (% of GDP)							
Revenue 4/	19.4	18.6	20.2	18.6	19.5	19.7	19.7
Expenditure	27.8	28.0	27.8	26.7	26.5	27.0	26.8
Deficit	8.4	9.4	7.6	8.1	7.0	7.3	7.1
Total Debt 5/	74.9	73.3	67.9	67.9	68.7	70.8	70.5
Domestic	69.8	68.6	63.4	63.2	64.3	66.4	66.7
External	5.1	4.7	4.5	4.7	4.4	4.5	3.8

Notes:
1/ Consumption is equal to final consumption expenditure plus valuables. History includes national accounts' discrepancies.
2/ Gross fixed capital formation
3/ Excluding gold, SDR and IMF reserve position
4/ Includes receipts from 3G spectrum auctions and disinvestment
5/ General government liabilities include states' holding of short-term central govt securities

Sources: Central Statistics Office, Reserve Bank of India, and World Bank Staff Estimates.