India—Assessment Letter for the Asian Development Bank
August 14, 2014

This note provides the IMF staff's current assessment of India's macroeconomic conditions, prospects, and policies. The assessment has been requested in relation to proposed development loans to be considered by the Asian Development Bank in September 2014.

Overview. The near-term outlook and balance of risks for India are more favorable than foreseen in early 2014, following the unwinding of external imbalances and accompanying reserve buildup, helping to reduce external vulnerabilities. However, important challenges remain in boosting growth, bringing down inflation, and strengthening public finances.

Growth and Inflation. Real GDP growth slowed from about 9 percent in 2010/11 to below 5 percent in 2012/13 and 2013/14 (April-March FY). Led by falling infrastructure and corporate investment, the slowdown weakened the financial position of banks and corporates. However, growth has bottomed out and is projected to recover to 5.4 percent in 2014/15 (at factor cost), assuming no major legislative reforms. Stronger global growth and a recent pick up in sentiment should combine to deliver this modest growth rebound, despite headwinds from ongoing fiscal consolidation and a tighter monetary stance. Headline CPI inflation is expected to decline gradually, from about 9.5 percent in 2013/14 to 8.3 percent in 2014/15 and 7.5 percent in 2015/16, supported by prudent monetary policy and reforms aimed at alleviating supply-side constraints.

External Position. The current account deficit (CAD), having reached a record-high 4.7 percent of GDP in 2012/13, narrowed sharply to 1.7 percent in 2013/14, due mainly to administrative restrictions on gold imports, but also weaker domestic demand and a strengthening of export competitiveness accompanying the more depreciated rupee. The CAD is likely to widen slightly to around 2¼ percent of GDP in 2014/15, and is expected to be financed mainly by FDI and portfolio inflows, supported by recent steps to further liberalize inflows, which have resulted in large balance of payments surpluses in 2013/14 and Q1 of 2014/15. Gross reserves have recovered from mid-2013 lows, rising from US$275 billion at end-August 2013 to reach US$318 billion at mid-July 2014 (over 6 months of imports). In line with the IMF's 2014 Pilot External Sector Report, the external sector position appears broadly consistent with medium-term fundamentals and desirable policy settings, with the rupee assessed to be broadly in line with fundamentals.

Fiscal Policy. The 2013/14 Budget outturn for the central government was tighter than expected, yielding a fiscal deficit of about 4½ percent of GDP (authorities' definition). In this regard, staff welcomes the recently-passed 2014/15 Budget, which continues the adjustment path, with the deficit expected to decline further to 4.1 percent of GDP (authorities' definition, equivalent to 4½ percent using IMF definition). The government should continue to adhere to the roadmap for fiscal adjustment, which aims to reduce the central government deficit to about 3 percent of GDP by 2016/17. A key medium-term objective of the new government is to put in place the Goods and Services Tax (GST), which will boost growth by reducing barriers to inter-state trade. India's public debt (about 66 percent of GDP) is relatively high, but owing to a favorable growth-interest differential, debt is projected to remain sustainable (including under stress scenarios). Comprehensive tax and subsidy reforms are needed to durably lower fiscal imbalances, which would allow room to increase infrastructure and social spending.

Monetary Policy. The Reserve Bank of India has maintained a fairly tight monetary policy stance since the volatility of May–August 2013, hiking policy rates by a cumulative 75 basis points in September–October 2013, and is now exploring the option of introducing a form of flexible inflation targeting. Nonetheless, policy rates need to gradually rise to bring real rates into positive territory and reverse persistently-high inflation expectations.

Financial Sector. Growth in private sector credit has decelerated further, with nonfood bank credit growth slowing to 14 percent y/y by March-2014, from over 21 percent in 2010/11. Banks remain adequately capitalized, but as a result of last year's slowdown, non-performing loan ratios have risen from 3.4 percent in early 2013 to 4 percent at March 2014, especially for public sector banks, and balance sheets are showing signs of stress. Continued progress on enhancing financial sector regulation and supervision will help tackle financial sector strains.

Structural Agenda. Returning to robust real GDP growth rates will require progress on several fronts. While the government has accelerated the pace of project approvals and encouraged their implementation, further work is needed in addressing problems in the power and mining sectors, and implementing long-awaited reforms such as the introduction of GST, comprehensive subsidy reform, and labor market measures to improve flexibility. As well, broadening access to finance, taking steps to boost agricultural productivity, raising spending on health and education, and strengthening governance to improve the delivery of public services, will support growth and make it more inclusive.

Risks. The balance of risks remains tilted to the downside. Protracted economic and financial volatility (potentially triggered by advanced economies' exit from unconventional monetary policies) or higher world oil prices are the main external risks. Key domestic risks include the failure to adopt structural reforms, tackle high inflation, ease supply constraints, and bring down public debt over the medium term.

Medium-term Challenges. Over the medium term, India's growth potential is in the neighborhood of 6¾ percent, though reaching this level will require accelerating the pace of project approvals and implementation, while addressing supply bottlenecks, particularly in the mining and power sectors. Achieving even higher potential growth will require wide-ranging structural reforms, including reforming agricultural production and marketing, improving natural resource pricing and allocation, easing restrictive labor laws, and continued fiscal consolidation to create space to increase infrastructure spending.

IMF Relations. On January 27, 2014, the IMF's Executive Board concluded the 2014 Article IV Consultation. A joint IMF-World Bank Financial Sector Assessment was completed in 2012. The next Article IV Consultation is expected to take place later this year.