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# India Development Update

WORLD BANK GROUP
Macroeconomics & Fiscal Management

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*This Update was prepared by Denis Medvedev (GTCDR), Saurabh Shome, Smriti Seth, and Jaba Misra (GMFDR) under the guidance of Vinaya Swaroop (Practice Manager, GMFDR), Zahid Hussain (Lead Economist, GMFDR), and P. S. Srinivas (Practice Manager, GTCDR) and on the basis of discussions with experts in New Delhi's think tanks and policy making circles. Gunjan Gulati (CSASC), Neeti Katoch, Varsha Marathe, Anuradha Ray, and Niraj Verma (GFMDR) authored the financial sector analysis, while Tehmina Khan (DECPG) authored the global developments section. Luke Simon Jordan, Bertine Kamphuis, Aman Khanna, and Denis Medvedev (GTCDR) authored the special topic section. Onno Ruhl (Country Director, SACIN) and Marcelo Giugale (Senior Director, GMFDR) 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. The special topic of this Update is the impact of supply chain delays and uncertainty on manufacturing growth.*

## Executive Summary

*Growth rebounded significantly due to strong industrial recovery aided by growth in investment and exports. Capital flows are back, signaling growing investor confidence, as inflation has moderated from double digits, exchange rate has stabilized, and financial sector stress has plateaued. Monetary policy continuity has been maintained and there has been some progress on fiscal consolidation. With the economy still below potential and reform momentum picking up, growth is expected to strengthen over the medium-term. Inflation is expected to decline with monetary policy switching to inflation targeting while the current account deficit is expected to widen somewhat as import demand and capital inflows rise. Fiscal consolidation is expected to continue through stronger revenue mobilization. Downside domestic risks can be offset through accelerated structural reforms.*

**Growth rebounded strongly in the first quarter of fiscal year 2015 (Q1 FY2015) as industrial activity accelerated**. While the services sector continues to be the main engine of the Indian economy, growth improved to 5.7 percent year over year in Q1 FY2015 mainly because industrial activity accelerated to 4.2 percent year over year, the fastest pace since Q4 FY2012. Activities related to construction, electricity, gas and water supply grew robustly and demand for capital and basic goods increased. Investment accelerated sharply to 7 percent year-over-year in Q1 FY2014 from an average growth of 0.3 percent year-over-year since Q1 FY2013. Agricultural activity slowed in Q1 FY2014 as the untimely rains in March adversely affected the winter crop.

**The current account deficit narrowed to pre-global crisis levels and capital inflows surged.** The 18 percent depreciation in the rupee between May and August, 2013, and the recovery in India's major export markets helped stimulate export demand. Simultaneously, restrictions on gold imports, stable global crude prices, and rising import costs due to exchange rate depreciation reduced imports. Consequently, the Q1 FY2015 current account deficit came down to 1.6 percent of GDP, close to pre-global crisis levels. Capital flows improved markedly as both portfolio investments by Foreign Institutional Investors (FIIs) and Foreign Direct Investment (FDI) increased, with the reserve coverage rising to almost seven months of imports. Following last year's depreciation episode, the exchange rate has remained stable and recovered more than half of its losses from the lowest point.

**Inflation has moderated from double digits as food and fuel price growth has eased.** Consumer inflation has been trending downwards since January 2014 but remains elevated at 8.0 percent year-over-year. Despite easing momentum, growth in prices of food products outpaces price growth in other categories. Upside risks stem from volatile prices of certain food categories, especially vegetable prices and a widening supply-demand gap driven by changing consumer preferences. Fuel inflation moderated due to declining global crude prices that led to price corrections in bulk diesel and other oil distillates.

**Faced with slowing credit growth and upside risks to inflation, the Reserve Bank of India (RBI) kept the policy rates unchanged.** Credit growth decelerated to 10.5 percent year-over-year in August, continuing the declining trend since March, 2014. In order to provide sufficient liquidity in support of the economic recovery while simultaneously remaining vigilant against inflation, the RBI kept the policy repo rate unchanged at 8 percent while lowering the Statutory Liquidity Ratio from 23 percent to 22 percent.

**Financial sector stresses have plateaued, but the sector's overall health will need to be watched closely.** Though gross non-performing assets (NPAs) remain high, overall stressed assets are showing signs of containment with the banking sector focused on ensuring that further slippages into bad loans are arrested in a timely manner. However, profitability continues to be strained as balance sheets of banks are still weighed down by impaired loans which could constrain their ability to raise capital in the medium term. The corporate sector is showing signs of revival, supported by positive business sentiment, while the Indian stock market has outperformed developed and peer emerging markets over the last six months. On the regulatory front, the RBI's new guidelines boosted the recovery mechanisms, such as sales to asset reconstruction companies (ARCs). In the infrastructure space, the bulk contributor to NPAs, recent measures saw relaxation of norms to aid long term financing.

**The fiscal deficit of the central government outperformed the target.** The FY2014 fiscal deficit came in at 4.6 percent of GDP, 0.2 percent of GDP better than target. This was achieved through a combination of expenditure compression—primarily in social services and infrastructure—and larger non-tax revenues, including one-time telecom spectrum auction receipts and dividends from Coal India. While revenues and grants reached 9.3 percent of GDP, the highest level in two years, they still lagged behind budget estimates. This trend has so far continued in the current fiscal, as weak tax revenue collection has resulted in the central government incurring close to 75 percent of the annual fiscal deficit in the first five months of the year, compared with an average of 66.4 percent for the same period in the previous three years.

**Subsidy spending exceeded the budgeted amount in FY2014, but the FY2015 subsidy burden is likely to ease.** In FY2014, subsidy expenditures came in at 2.3 percent of GDP, exceeding the budgeted target by 0.3 percentage points. This occurred largely due to greater-than-budgeted oil subsidies, despite rolling over 0.3 percent of GDP worth of subsidies from FY2014 to FY2015. Although this move left little space for subsidy spending in FY2015, a decline in global oil prices and gradual increases in the domestic price of diesel have pushed under-recoveries on diesel to zero by mid-September 2014. The announced deregulation of diesel in October 2014 will limit further liabilities and keep the oil subsidy bill contained, most likely below 0.6 percent of GDP.

**The reforms pace has gained momentum.** The authorities' focus on efficient and effective implementation has been borne out in actions to expedite decision making and clearance procedures for large projects. New reform steps include actions to deregulate diesel prices, reform labor laws, facilitate regulatory compliance, simplify land acquisition and environmental clearances, and improve financial inclusion. The authorities also raised FDI limits in key sectors and took measures to deepen financial markets. In addition, a new Expenditure Management Commission was established to rationalize public spending (including subsidies), while the long-standing Planning Commission will be disbanded in favor of an economic advisory body.

**Growth is expected to improve to 5.6 percent in FY2015.** India's long-run growth potential remains high due to favorable demographics, relatively high savings and policies and efforts to improve skills and education, facilitate domestic market integration, and incentivize manufacturing activities. Under the baseline scenario in this Update, growth is expected to rise to 5.6 percent in FY2015, followed by further acceleration to 6.4 percent and 7.0 percent in FY2016 and FY2017. Externally, the scenario is predicated on exports boost from improving growth and job prospects in the United States and largely stable or declining crude prices. External shocks, including financial market disruptions arising out of changes in monetary policy in high income countries (particularly in the United States), slower global growth, higher oil prices, and adverse investor sentiment arising out of geo-political tensions in the Middle East and Eastern Europe could have adverse consequences for the baseline trajectory. Domestically, risks include challenges to energy supply and fiscal pressures from weak revenue collection in the short term and the Seventh Pay Commission's recommendations on public sector remuneration in the medium term. On the other hand, further progress on the reform agenda—particularly the implementation of the Goods and Services Tax (GST), which could transform India into a common market and dramatically boost competitiveness—could help offset both domestic and external risks to the outlook.

**Supply chain delays and uncertainty are a major, yet underappreciated, constraint to manufacturing growth and competitiveness**. Regulatory impediments to the movement of goods across state borders raise truck transit times by as much as one quarter, and put Indian manufacturing firms at a significant disadvantage vis-à-vis international competitors. State border check-points, tasked primarily for carrying out compliance procedures for the diverse sales and entry tax requirements of different states, combine with other delays to keep trucks from moving during 60 percent of the entire transit time. Long transit times and high variability and unpredictability in shipments add to total logistics costs in the form of higher-than-optimal buffer stocks and lost sales, pushing logistics costs in India to two-three times international benchmarks.

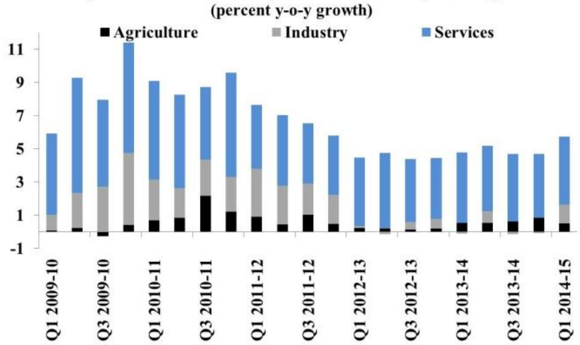
**Implementation of the GST, combined with dismantling of inter-state check-posts, is the most crucial reform that could improve competitiveness of India's manufacturing sector**. The GST offers a unique opportunity to rationalize and re-engineer logistics networks in India, given the inherent inefficiencies with taxes based on the crossing of administrative boundaries. The GST will free up decisions on warehousing and distribution from tax considerations so that operational and logistics efficiency determines the location and movement of goods. Freight and logistics networks will realign according to the location of production and consumption activities, creating the hub-and-spoke models that are needed to improve freight and logistics performance. Simply halving the delays due to road blocks, tolls and other stoppages could cut freight times by some 20-30 percent and logistics costs by an even higher 30-40 percent. This would be tantamount to a gain in competitiveness of some 3-4 percent of net sales for key manufacturing sectors, helping India return to a path of high growth and enabling large-scale job creation.

# 1. Recent Economic Developments

## 1.1 Real sector activity

**Growth accelerated in the first quarter of FY2015 (Q1 FY2015) as industrial activity picked up.**[1] Real GDP growth at factor cost improved to 5.7 percent year-over-year, the fastest pace in the past eight quarters, while on a quarter-over-quarter seasonally adjusted annual rate (saar) basis the pick-up was even sharper at 6.1 percent. The acceleration was mostly due to a sharp uptick in industrial activity that grew at 4.2 percent year-over-year after contracting for two previous quarters and registering an average growth of 0.7 percent year-over-year since Q1 FY2013. The acceleration amounted to a near-quadrupling of the industrial sector's contribution to growth, which rose to 19.7 percent in Q1 vs. an average of 5.6 percent since FY2013. The services sector grew at 6.5 percent saar, continuing its earlier trend, while agricultural growth moderated.

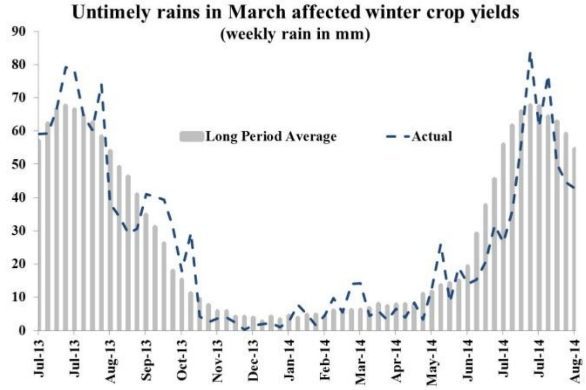
Pickup in industrial activity accelerated the pace of growth
(percent y-o-y growth)




Source: Central Statistics Office and World Bank Staff estimates

**Agricultural growth lost momentum as the winter crop suffered from untimely rains.** Due to a good monsoon season in 2013, agricultural growth reached 10 percent saar in the last quarter of FY2014. However, despite sufficient levels of soil moisture and recharged reservoirs, winter crop (*Rabi)* yields suffered due to untimely rains and hailstorm in March 2014, which affected the standing crop, especially in the states of Maharashtra, Madhya Pradesh and Punjab. Consequently, agriculture contracted by 1.1 percent saar in Q1 FY2015. Going forward, deficient rainfall in the ongoing monsoon season is likely to lower agricultural growth in the current fiscal—affecting both the summer (*Kharif*) and the winter (*Rabi*) crop cycles.

Untimely rains in March affected winter crop yields
(weekly rain in mm)

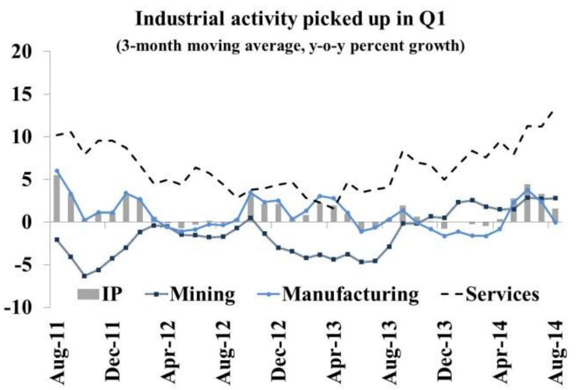



Source: Indian Meteorological Department

**Industrial activity rebounded sharply.** After contracting in the last two quarters of the previous fiscal year, industrial growth accelerated to 4.2 percent year-over-year, the highest outturn in the last eight quarters. The uptick was broad based across all sectors, with mining and manufacturing growth expanding after two quarters of contraction. Construction activities that had almost stagnated in the previous two quarters accelerated, while growth in electricity, gas and water supply soared to double digits— a pace last witnessed between July and September, 2011. Investment growth picked up sharply to 7 percent year-over-year in Q1, the fastest in eight quarters. Demand for capital goods and basic goods grew at a healthy pace, especially capital goods that accelerated to double digits (13.6 percent) from negative growth in the previous quarter. The sharpest growth was in machinery and equipment, led by strong growth in electrical machinery and apparatus, required predominantly in the manufacturing sector. On the other hand, demand for equipment required primarily in the services sector such as office and computing machinery and communication equipment, contracted. Similarly, demand for basic metals picked up to 11.4 percent from below 4 percent in the previous quarter. Demand for consumer goods remains depressed with the quarterly average year-over-year growth for consumer

[1] Throughout the document, FY2015 refers to fiscal year ending March 31, 2015.

durables continuing to contract while that for non-durables stagnating below 1 percent.



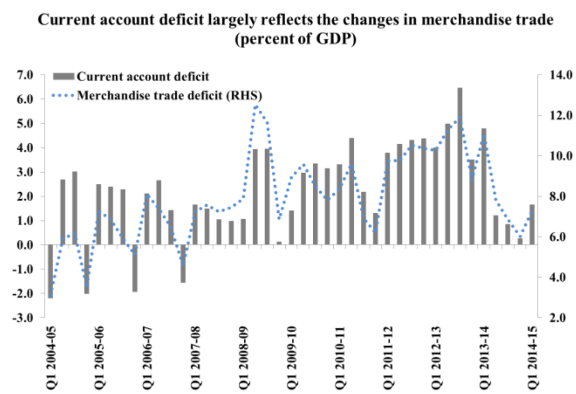

Source: Central Statistics Office and World Bank Staff estimates

**The services sector continued to be the main driver of growth.** The services sector, which accounts for more than half of GDP, grew at 6.5 percent saar in Q1 FY2015, consistent with the trend average of 6.6 percent saar since Q2 FY2012 but well below the double digit growth rates witnessed between 2009 and 2011. On a year-over-year basis, the services sector grew at 5.7 percent year-over-year in Q1 FY2015, accounting for 4.1 percentage points of the 5.7 percent GDP growth in Q1 FY2015. The largest contributors, financing, insurance and real estate services, accounted for 2.2 percentage points—followed by community, social and personal services, all of which contributed 1.1 percentage points.

## 1.2 Balance of payments

**India's external balances improved as the current account deficit narrowed and capital inflows surged.** Muted merchandise imports coupled with continued improvement in global export demand helped contain the current account deficit at 1.6 percent of GDP in Q1 FY2015. While higher than the 0.8 percent of GDP average over the last three quarters, this result was well below the FY2014 deficit of 1.7 percent of GDP. Foreign investment inflows (direct and institutional) regained strength and increased to 4.3 percent of GDP during Q1 FY2015 from 1.4 percent during FY2014. As a result, the overall balance of payments improved and foreign reserves in Q1 increased by US$11.2 billion, reaching US$316 billion or 6.9 months of imports.

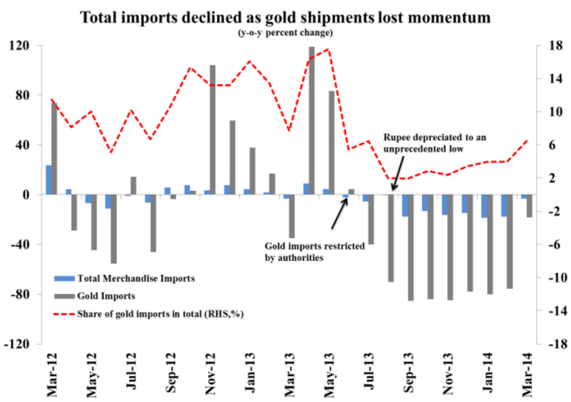
**The current account is returning to pre-global crisis levels.** The current account balance transitioned through several shifts over the past decade, deteriorating from a surplus of 0.3 percent of GDP in the five years before the global crisis (FY2004-2008) to an average deficit of 3.3 percent of GDP during FY2009-2013. However, following the rupee depreciation in the summer of FY2014, the current account deficit narrowed to a near decade-low of 0.2 percent of GDP in Q4 FY2014 due to improved export competitiveness and a sharp contraction in imports. As Q1 FY2015 showed some signs of revival in import demand, the current account deficit widened, but remained low and near pre-crisis levels. Movements in the current account deficit have closely mirrored the merchandise trade gap which narrowed from 10.5 percent of GDP in FY2013 to 7.8 percent in FY2014, and further to 7.3 percent in Q1 FY2015.




**Sharp decline in imports helped close the merchandise trade gap.** Merchandise imports contracted by 7.2 percent during FY2014, as the nearly 20 percent depreciation of the rupee in the summer of 2013 pushed up import costs and led to a contraction in import demand[2]. Furthermore, gold, which accounted for 11

[2] The trade balance worsened initially as imports were inelastic in the short run while exports took some time to respond. After the initial deterioration, however, the trade balance improved as exports volumes rose while imports volumes declined, following the J-curve effect.

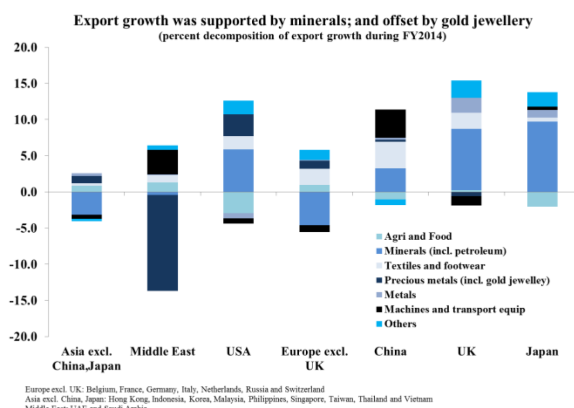
percent of total imports in FY2013, declined by 47 percent in FY2014 after authorities raised duties and imposed quantitative restrictions on its imports. In addition to gold, the decline was driven by capital goods and iron and steel imports which shrunk by 11 percent and 26 percent during FY2014. However, import demand increased somewhat during Q1 FY2015 in line with the overall economic recovery. The decline in merchandise imports moderated from 13.6 percent during the second half of FY2014 to 6.5 percent year-over-year during Q1 FY2015.




**Export growth strengthened on account of improved global demand.** Merchandise exports grew by 3.9 percent in FY2014 and strengthened further to 10.6 percent in Q1 FY2015— driven primarily by more robust demand from the United States, the United Kingdom, Japan and China which, together, account for 22 percent of all exports. As economic conditions improved in the United States, India's largest export destination (12.5 percent of all merchandise exports), shipments grew by 8 percent during FY2014 and further by 6.4 percent year-over-year during Q1 FY2015. Exports to the United States primarily consist of precious metals and jewelry (20 percent), textiles and footwear (18 percent), machines and transport equipment (11 percent) and petroleum (10 percent). Simultaneously, commensurate with the European Union's slower economic recovery, exports to EU countries registered a growth of 2.3 percent during FY2014, compared to -4 percent in the previous year. However, countries within the European Union performed differently: on the one hand, exports to the United Kingdom grew at 13.5 percent on account of increased petroleum and metal exports, which together account for 20 percent of all shipments to the country. On the other hand, exports to seven other major EU countries remained largely unchanged with a growth of 0.3 percent during FY2014.[3]

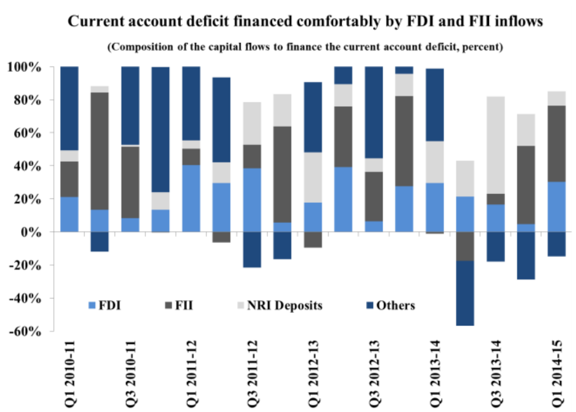
**The shift in the export destination of refined petroleum products drove the changes in overall export trends.** Refined petroleum is India's largest export at 20 percent of the total. In FY2014, the share of refined petroleum exports to the United States, the United Kingdom, and Japan increased from 7.7 percent in FY2013 to 12.7 percent and constituted the primary driver of increased export demand from these countries. Conversely, originally large recipients, Netherlands and France, mirrored that increase with a sharp decline, from 13 percent of total petroleum exports in FY2013 to 8 percent in FY2014.

**Gold jewelry exports fell by 24 percent due to restrictions on imports of raw gold.** Exports to the United Arab Emirates, India's second largest export destination, fell by 16 percent due to a 32 percent reduction in jewelry exports. However, some of the decline in jewelry was offset by a 12 percent increase in diamond exports, mainly to the United States and Hong Kong.

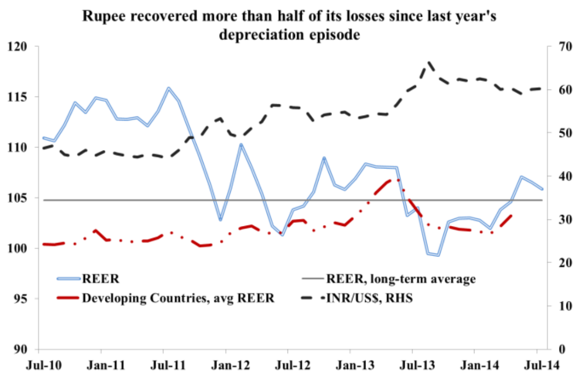



[3] Belgium, France, Germany, Italy, Netherlands, Russia and Switzerland account for 86 percent of total exports to the European Union (excluding the United Kingdom).

**Growth in portfolio flows and foreign direct investment ensured adequate financing of the current account deficit.** In Q1 FY2015, capital inflows increased markedly to 3.7 percent of GDP from 2.4 percent during FY2014. This increase was supported primarily by higher FII inflows which rose to 2.6 percent of GDP from 0.3 percent as global investor sentiment improved. FDI inflows also benefitted from big investments by Vodafone (US$1.5 billion) and Abbott (US$450 million) and increased to 1.7 percent of GDP during Apr-Jun 2014 from 1.1 percent during FY2014. Non-resident Indian (NRI) deposits, which surged to 2.1 percent of GDP during FY2014 in response to steps taken by RBI to liberalize currency swaps in September 2013, returned to their average historical level of around 0.5 percent of GDP. [4]




**The currency has regained strength following last summer's bout of depreciation.** Similar to other emerging markets, the rupee depreciated by 18 percent between May and August 2013 as global investors fretted over fears of early Fed tapering. Since then, the rupee recovered by more than 9 percent and stabilized around INR60/US$ as global market fears subsided, growth in high income economies continued to improve, and the current account deficit narrowed. Due to improved external balances, India was better insulated from further shocks when the actual Fed tapering began in December and further moves by the Fed had little impact on the exchange rate. The real effective exchange rate (REER) mostly mirrored the movement of the nominal exchange rate and appreciated by 6.4 percent since August 2013, but remained more competitive than before the depreciation episode due to moderation in domestic inflationary pressures.



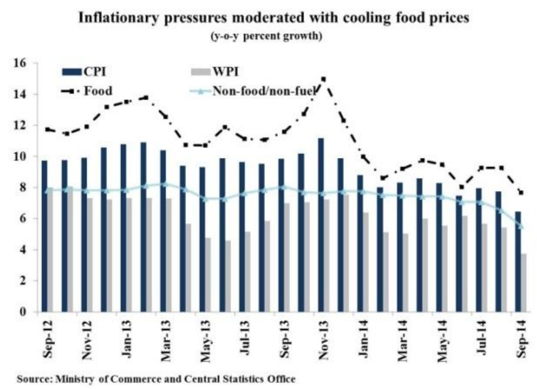

**External debt rose on higher deposits by non-resident Indians.** During FY2014, total external obligations rose by 7.6 percent to US$440.6 billion or 23 percent of GDP. The increase was primarily due to a 47 percent increase in NRI deposits, reflecting the impact of fresh deposits mobilized under the currency swap scheme during September-November 2013 by the RBI. However, short-term obligations improved: debt due for maturity within one year declined to US$114 billion (37.5 percent of foreign exchange reserves), or 6 percent of GDP from 6.2 percent of GDP the previous year. Sovereign external debt registered a small decline to US$81.5 billion or 4.3 percent of GDP at the end of March 2014, from US$81.7 billion or 4.4 percent of GDP a year ago. Multilateral or bilateral credit continued to account for nearly 80 percent of overall sovereign debt.

## 1.3 Inflation

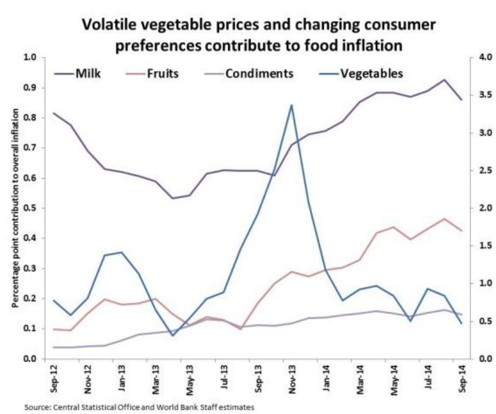
**Consumer inflation has fallen to a record low of 6.5 percent due to easing food prices.** Following an uptick in July, consumer inflation declined to 6.5 percent year-over-year in September, the lowest outturn in the four year history of the new Consumer Price Index.

[4] The RBI provided a facility for Indian banks to swap forex liabilities against Foreign Currency Non-Resident, Bank (FCNR B) deposits at a fixed cost of 3.5 percent per annum, compared to market rates of around 6-8 percent in September 2013.

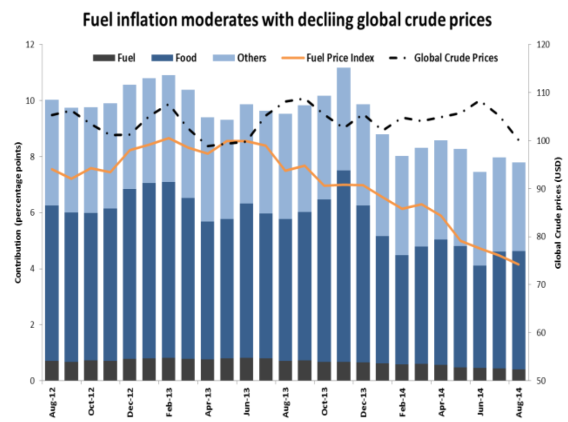
Despite the deceleration, inflation nonetheless remains relatively high, averaging 8.0 percent year-over-year since January 2014. Food prices continue to be the main contributor to the rate of inflation as well as the recent slowdown: in FY2015, prices of food have grown at an average rate of 9.0 percent and have contributed 52 percent to overall inflation, more than its 50 percent weight in the overall CPI.




**Food price growth remains high and volatile.** Within food, cereals have been the largest contributor, primarily due to their larger weight in the consumption basket. However, other prices have been growing much more rapidly, with vegetables, fruits, and milk and milk products registering double-digit price growth. Since January, growth in milk and vegetable prices has contributed 0.9 and 0.8 percentage points, respectively, to the average overall inflation of 8.0 percent. While the contribution of vegetable prices to overall inflation has been volatile (the July uptick in inflation was mostly due to a spike in vegetable prices), that of milk, milk products and fruits has been on a steady rise since mid-2013.



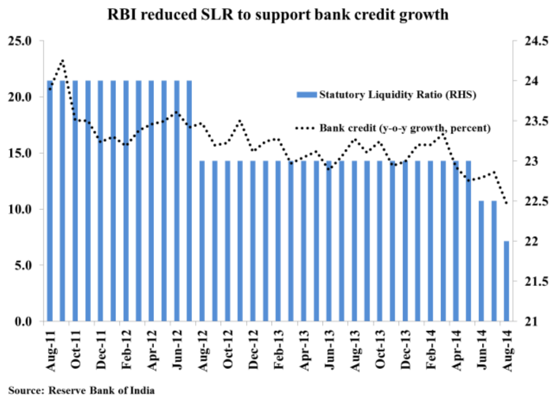

**The decline in global crude prices eased pressures on fuel prices.** Drop in the global crude oil prices has led to a moderation in fuel inflation to an all-time low of 3.5 percent year-over-year in August 2014. Similarly, wholesale inflation in fuel and power fell sharply to 4.5 percent year-over-year in August 2014, after averaging 9.5 percent since January 2013 when authorities began the selective deregulation of diesel prices for bulk consumers and allowed a phased administered price increase for retail consumers.[5] The largest contribution to the slowdown came from moderating bulk diesel, petrol and naphtha prices. However, upside risks remain from global commodity prices in view of the ongoing instability in the Middle-East.




**The central bank kept the policy rate unchanged while easing liquidity provisions to support credit growth.** The downward trend in inflation appears to be on track to meet the recommendations of the RBI panel report on a new approach to monetary policy (Box 1). However, upside risks remain from volatility in the prices of some food groups, especially vegetables, fruits and milk. Cognizant of a delicate balance between remaining vigilant against inflation and supporting the nascent economic recovery, the RBI has kept its policy rates unchanged at 8 percent after raising it by 75 basis points in January 2014. Instead, the central bank chose to ease reserve norms to free up resources for expanding bank credit. Overall credit growth has continued to decelerate since March 2014, falling to 10.5 percent year on year

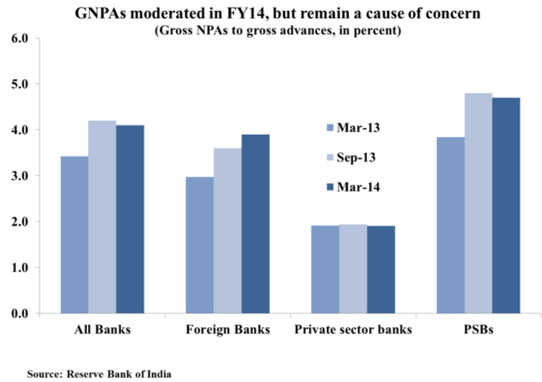
[5] Bulk users consume approximately 18 percent of the total diesel consumption in India.

in August this year from 16 percent last year. Consequently, the RBI lowered the Statutory Liquidity Ratio (SLR)[6] of commercial banks on two occasions—May and July—correcting it by 50 basis points each time from 23 percent to 22 percent of their Net Demand and Time Liabilities (NDTLs). Simultaneously, liquidity provisions were revised to improve monetary policy transmission; access to funds under the Liquidity Adjustment Facility (which is available at the prevailing repo rate) was raised by 25 basis points to 1 percent of NDTLs, and commensurate restrictions imposed on other provisions, to maintain overall liquidity.




## 1.4 Financial sector

**Despite recent improvements in asset quality, non-performing assets remain high**. Lower slippages, a seasonal pattern of higher recovery, write-offs during the last quarter of FY2014, and sales of NPAs to ARCs contributed to some improvement in asset quality. As a result, gross NPAs (GNPAs) in the banking sector declined to 4.0 percent in Q4 FY2014 from 4.4 percent at the end of the previous quarter, although they remain well above 3.4 percent recorded at the end of FY2013. Overall stressed assets, which include restructured standard advances, also came down from 10.2 percent of total advances in Q2 FY2014 to 9.8 percent in Q4 FY2014. Though GNPAs increased marginally between March and June 2014, there has been a significant drop in fresh referrals to the Corporate Debt Restructuring (CDR) Cell for restructuring in this period. The authorities also took steps to contain the NPAs in the infrastructure sector, which contribute to almost half of the total stressed assets of banks.[7] Further, industry reports suggest that the proportions of loans in sectors with negative outlook shrank while loans to sectors with stable outlook increased in FY2014.[8]




**Stronger corporate balance sheets have been one of the main drivers behind improvements in asset quality**. About 70 percent of aggregated balance sheet debt of BSE500 corporates (excluding financial services) belongs to net importers and the rupee appreciation improved the credit metrics of these companies.[9] Another industry analysis of 2,500 listed corporates indicated a modest improvement in the interest coverage ratio from 2.3 in FY2014 to 2.5 in Q1 FY2015– the first such improvement in 16 quarters.[10] An RBI survey of non-government non-financial companies also indicates similar trends in terms of decline in interest expense and improvement in interest coverage. However, overall sales and operating profits of the corporates, except information technology (IT) firms, saw a contraction.

[6] SLR is the minimum percentage of deposits in approved securities that banks must maintain.

[7] India Development Update March 2014 discussed infrastructure sector's contribution to NPAs of SCBs

[8] Corporate Risk Radar, 2014-2015, India Ratings and Research, June 2014

[9] S&P BSE 500 index represents nearly 93% of the total market capitalization on the Bombay Stock Exchange, covering 20 major industries.

[10] Nomura Corporate Health check – June 2014

**Box 1: Key recommendations of the Expert Committee to Revise and Strengthen the Monetary Policy Framework**

The report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework is organized in four principal parts, each part dealing with the subject of the nominal anchor, the organizational structure for taking monetary policy decisions, changes to the operating framework, and removing hurdles to monetary policy transmission. The choice of the CPI (combined) as the nominal anchor is likely to enhance policy communication and hence expected to more effectively affect inflation expectations and improve monetary policy transmission. A committee based organizational structure, with enhanced research support, aims at reducing discretionary policymaking. The operating framework recommendations strive to reduce volatility and reduce the RBIs role in government financial management. Finally, removing hurdles to policy transmission are a mix of recommendations for reducing financial market distortions arising out of government policy and actions and enhancing conventional monetary safeguards in a global context.

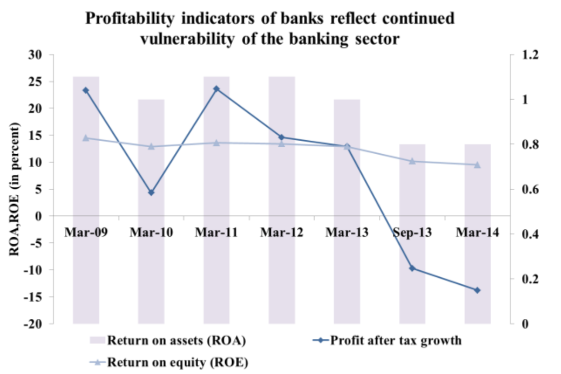
**Nominal anchor**: The report recommends that inflation should be the nominal anchor for monetary policy framework, measured by the new CPI (Combined) index. The recommended nominal target is 4 +/- 2 percent, to be adopted after a phased inflation reduction plan targeting 8 percent inflation in the first 12 months and 6 percent inflation in the following 12 months. Although close to 50 percent of the weight in the index pertains to food and fuel—commodities for which monetary policy has limited direct effect—research suggests that inflation expectations are more closely correlated and tend to persist longer with CPI inflation than WPI.

**Organizational structure**: The report proposes that monetary policy decision-making be vested in a five-member Monetary Policy Committee (MPC) composed of the RBI Governor (Chairman), the Deputy Governor in charge of Monetary Policy (Vice Chairman), and three members: the Executive Director in charge of Monetary Policy and two external members chose by the Chairman and Vice Chairman. The MPC will vote on the policy and will be accountable for failing to meet the inflation target for three consecutive quarters. In order to support MPC decision-making, the RBI's Monetary Policy Department will be significantly reorganized to enhance research support.

**Operating Framework**: The report proposes that the MPC target a positive real policy rate, keeping in mind the output gap. In Phase I of the implementation of the new framework, the currently used overnight Liquidity Assessment Facility (LAF) repo rate will continue as the policy rate but it will be restricted to a specified ratio of bank-wise Net Demand and Time Liabilities (NDTL). Concurrently, as the 14 day term repo rate stabilizes, it will to be used increasingly to provide liquidity to banks with the aim of transitioning the 14 day term repo rate as the policy rate. In Phase II, as the 14 day term repo rate gains acceptance, it will replace the overnight repo rate as the policy rate. The RBI expects that 14 day term repo rate will improve monetary policy transmission by discouraging the use of the overnight repo rate as the first liquidity management option by banks thereby assisting in the development of markets that price and hedge risks. Simultaneously, the MSF rate will be set high enough to be perceived and consequently used as a facility to be used only in exceptional circumstances.

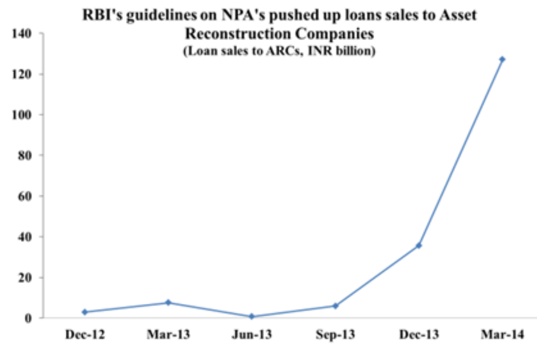
The framework also proposes that debt and cash management of the government to be under the Government and not the RBI, and instruments such as the Market Stabilization Scheme (MSS), Cash Management Bills (CMB), and Sector-specific refinancing will be phased out. Finally, the framework suggests reducing the Statutory Liquidity Ratio (SLR) in keeping with BASEL III framework, minimizing government intervention in commercial banks, detaching open market operations from fiscal operations, and having greater forex reserves and instruments to deal with inflows and outflows.

**Bank profitability continues to be under pressure even as authorities roll out a large financial inclusion program.** The return on assets remained similar to last year while return on equity declined in FY2014 as banks faced lower profitability coupled with fresh capital infusion requirements following the roll-out of Basel III norms in April 2013. Weak financial performance of public sector banks is evident in their contributing just 41 percent of the total profit after tax (as compared to over 65 percent in 2010), even though their share in total banking sector assets is around 70 percent. As a result of continued stresses in the banking system, bank credit growth declined to 13.6 percent by the end of FY2014 from 15.1 percent at the end of the previous fiscal. Under these conditions, the ability of Indian banks to service large volumes of low-income customers, as envisaged under the recently launched comprehensive financial inclusion campaign (see section 1.6), may be limited by several factors such as the burden of bad loans, lower profitability, need for higher capital, and existing priority sector obligations.



Source: Reserve Bank of India

**Recent RBI guidelines on NPAs have resulted in significant increases in sales to ARCs.** In the context of the deterioration in the asset quality of banks, recent RBI guidelines propose a corrective action plan that offers incentives for early identification of stressed assets by banks, timely revamp of accounts considered to be unviable, and prompt steps for recovery or sale of assets in the case of loans which are likely to turn NPAs. Consequently, banks (especially the public sector banks) have increased their sales of NPAs, to ARCs over the last few quarters.[11] Loan sales rose to an estimated 0.2 percent of total advances in March 2014 from a mere 0.01 percent six months prior; moreover, even after adjusting for ARC sales, total stressed assets appear to have plateaued. Going forward, the sale of NPAs to ARCs could decline with RBI, raising the Security Receipts (SR) invest and hold threshold from 5 percent to 15 percent. Nevertheless, trends in asset sales through SRs will need to be watched from the perspective of banks using it to mask existing vulnerabilities.



Source: Reserve Bank of India

**Other initiatives to reduce the NPA burden have had more limited success.** Another mode of recovering bad loans through The Securities and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, which allows banks and financial institutions to auction properties when borrowers fail to repay loans, has recovered only 27 percent of the INR681 billion worth of loans referred to it.[12] However, RBI's constant nudges for proactive action have stirred some banks to take severe measures. United Bank of India's recent declaration of the Chairman of United Breweries Group a 'wilful defaulter' may set pace for other banks to undertake serious measures for debt enforcement.[13]

**New infrastructure bonds could increase the availability of long term financing for credit-strapped infrastructure**. Loans to stalled infrastructure projects continue to drag down the books of Indian banks while financing for new projects remains limited. To address this issue, the RBI has now allowed banks to raise long term funding (tenor >7 years) for lending to infrastructure with minimum regulatory pre-

11 RBI's Financial Stability Report, June 2014

12 Operation and Performance of Commercial Banks, RBI, November 2013

13 RBI guidelines indicate that once tagged as wilful defaulters, business people can be barred from accessing India's financial markets and kept out of influential corporate positions.

emption (no cash reserve ratio, statutory liquidity ratio, or priority sector lending). Because of the relief in reserve requirements and priority sector credit target, such bonds could cost 60-100 basis points less than traditional CDs/short term deposits.[14] Market expectations of this policy indicate large debt market issuances in the Indian market.[15] Assets worth INR2.7-3.5 trillion could qualify for such funding in FY2015, depending on the interest rate differential between term deposits and bond rates. Insurance companies, pension and provident funds, FIIs, and retail investors are likely to be the early investors. However, the cushion available with insurance companies and pension funds for investments in corporate bonds is estimated to be less than INR1 trillion, which may emerge as a constraining factor for long-term bond issuances by banks. Thus, significant improvement in FII's investment appetite would hold the key for utilization of the initiative's full potential.

**Innovative financing vehicles are another potential source of funding for infrastructure.** The authorities have introduced new Infrastructure Investment Trusts (IInvTs), to be established along the lines of Real Estate Investment Trusts (REITs) to create new investor classes in infrastructure and enable banks to offload post commissioned assets to such IInvTs. These trusts will invest public money into completed and revenue generating infrastructure projects, while investments in projects under construction will be limited to 10 percent of assets.[16] Banks, international multilateral financial institutions, foreign portfolio investors (FPIs), including sovereign wealth funds, can come in as strategic investors in IInvTs. The units issued by these trusts, just like mutual funds, will also be compulsorily listed on the bourses, thus providing liquidity to investors. The success of the new instruments will depend on the ability of the financial sector to operationalize them quickly, as well as on the development of an ecosystem of domestic and overseas investors in long tenor infrastructure finance.

**Despite new initiatives, power sector finance remains a challenge.** Power sector finance accounts for 59 percent of the banking sector's nearly INR9 trillion exposure to infrastructure and could be adversely affected by recent Supreme Court rulings, including the allocation of coal blocks and the compensatory tariff for two large thermal projects that use imported Indonesian coal.[17] In deciding on the latter, the Supreme Court stayed a July 2014 order by the Appellate Tribunal for Electricity (APTEL) that allowed Tata Power Co. Ltd and Adani Power Ltd to charge higher prices for electricity produced from their plants in Mundra, Gujarat. In 2012, the Indonesian government changed rules and linked the prices of coal exports to spot market prices, which made ineffective provisions of long-term contracts signed by Indian firms with Indonesian miners. Such developments point to challenges in infrastructure project procurement, including in the design of contracts, and remain a key feature for policy to address.

## 1.5 Fiscal developments

**The central government's FY2014 fiscal deficit came in better than the target**. The FY2014 overall gross fiscal deficit was 4.6 percent of GDP, an improvement from the 4.8 percent recorded in FY2013 and the budgeted target of 4.8 percent of GDP for FY2014. Although the deficit remains well above the 3.4 percent of GDP average of FY2005-FY2008 and continues to exceed the adjustment path proposed by the Thirteenth Finance Commission, it has now declined for two consecutive years, reflecting the authorities' commitment to fiscal consolidation.

[14] The spread could fall to 30-70 basis points if interest rate differential between short-term deposits and long-term bonds were to widen. A recent bond transaction (Andhra Bank rated AA+ by CRISIL, INR10 billion Infrastructure Bonds), one of the first in the market post the new rules to be rated, is expected to cost 75basis points lower relative to long tenor deposits, on account of the special features of such instruments.

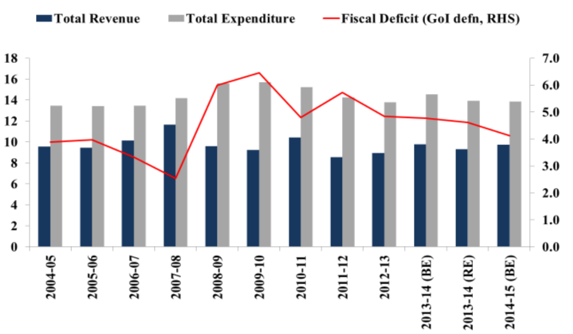
[15] ICRA Comments July 2014

[16] Counterpart funding would have to come from private placements in cases when projects under construction account for more than 10 percent of assets.

[17] Tata Power and Adani Power, both plants in Mundra Gujarat

**Revenues were the highest in two years, but lagged behind budget estimates.** In FY2014, total revenues and grants were at 9.3 percent of GDP, the highest outturn since FY2011.[18] Even so, all tax revenues (corporate, income, service, excise, and customs duties) remained below levels budgeted a year ago. The revenue shortfall, however, was somewhat compensated by unanticipated non-tax revenues which exceeded the target of 1.5 percent of GDP by 0.2 percentage points: INR611 billion (0.2 percent of GDP) telecom spectrum auction windfall and INR164 billion dividend from Coal India (0.1 percent of GDP).

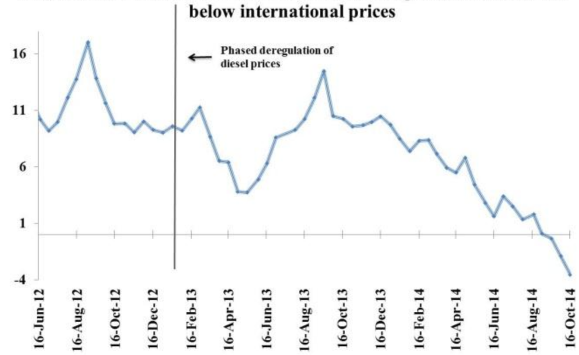
Central Government's finances improve
(percent of GDP)




**Expenditure restraint was achieved largely through cuts in social services and infrastructure.** Current expenditures were contained at 12.4 percent of GDP, 0.2 percent of GDP below budget but 0.1 percent of GDP higher than in FY2013. Similar to the adjustment at the end of FY2013, the cuts in current expenditures are mostly in social services, particularly in rural development, health and education. The largest cuts in capital expenditure were in telecommunications, power, and roads.

**Similar to prior years, subsidy expenditures exceeded budget estimates.** The authorities spent 2.3 percent of GDP on subsidies, 0.3 percentage points higher than the budgeted amount. Most of the increase came from higher spending on petroleum subsidies, which exceeded the budgeted amount of INR650 billion (0.6 percent of GDP) by more than INR200 billion (rising to 0.8 percent of GDP). This amount does not include INR 350 billion in oil subsidy spending which the authorities announced would be rolled over to the next fiscal year; counting the roll-over as FY2014 expenditure would push the oil subsidy bill to 1.1 percent of GDP.[19]

Diesel under-recoveries have been eliminated as production costs fell below international prices




Source: Ministry of petroleum and natural gas

**Subsidy spending has moderated in FY2015 as diesel prices reached parity with international levels.** Due to declining global oil prices, cost of domestic diesel production has remained below international prices since mid-September 2014. This has kept fuel subsidies contained and allowed the authorities to take the critical step of deregulating retail diesel prices in October 2014. Even prior to the reform, FY2015 under-recoveries by oil marketing companies were expected to decline by 35 percent from the previous year.[20] Since approximately half of these under-recoveries are borne by the government, fuel subsidies could decline to 0.6 percent of GDP or lower in FY2015 (including

[18] Discounting the exceptional non-tax revenue of 2.8 percent of GDP in 2011, this would mark the best revenue performance since the end of the global financial crisis.

[19] Note that FY2014 spending on oil subsidies also includes INR450 billion in roll-over from FY2013. The practice of rolling over oil subsidy spending is uncommon and no information is available on any roll-overs prior to FY2013. Moving the expenditure to the fiscal year in which it was incurred would imply the following overall subsidy bill: FY2013 3.0 percent of GDP, FY2014 2.2 percent, FY2015 1.7 percent (vs FY2013 2.5 percent, FY2014 2.3 percent, FY2015 2.0 percent as reported in the budget).

[20] According to the press release dated September 01, 2014 by the Ministry of Petroleum and Natural Gas.

the roll-over of INR350 billion from FY2014), compared to 0.8 percent of GDP in FY2014.

**Continued weakness in tax revenues could put pressure on the FY2015 deficit target**. According to the Controller General of Accounts, the central government incurred a fiscal deficit of 3.1 percent of GDP during the first five months of FY2015, equivalent to 74.9 percent of its fiscal deficit target for the year. In comparison, over the last three years, authorities ran an average deficit of 66.4 percent of the total budget estimate during the same period. A significant portion of the shortfall can be attributed to lower tax collection, in spite of some revival in economic activity: the central government collected just 19 percent of its total budgeted tax revenue between April and August 2014, compared with 22 percent of budget estimates over the same period last year. Excise revenues, which usually vary with manufacturing activity, declined by 3.6 percent year-over-year between April and August 2014 in spite of a 2.6 percent saar increase in manufacturing output in Q1 FY2015. Similarly, customs duties showed no year-over-year percentage improvement, notwithstanding the revival in import demand. However, divestment receipts are expected to pick up the pace during the coming months as the Cabinet recently cleared stake sales worth INR434 billion (0.3 percent of GDP) in the Oil and Natural Gas Corporation (ONGC), Coal India and the hydropower utility company NHPC Limited.

**Fiscal consolidation among the states remains mostly on track.** The combined fiscal deficit of all states increased to 2.3 percent of GDP during FY2013, compared to the budget estimate of 2.1 percent of GDP. However, even with the increase, the states remain below the deficit targets recommended by the Thirteenth Finance Commission. Total revenue collection rose above the budgeted target of 13 percent of GDP to 13.3 percent of GDP, a historical high, primarily due to own-tax revenues from value-added tax (VAT) and property transactions. However, this improvement was more than offset by higher development expenditures and capital outlay, which grew to 10.8 and 2.3 percent of GDP. Most of the increase in spending was due to higher social services expenditures on education, sports, arts and culture (by Punjab, Bihar, Uttar Pradesh and Tamil Nadu) and urban development (by Rajasthan, Bihar, Karnataka, Jharkhand, Chhattisgarh, Tamil Nadu and Haryana).

**General government debt registered a minor decline.** The ratio of general government's debt-to-GDP fell by more than 10 percentage points in the second half of the 2000s to near 67 percent, but did not decline further in FY2012-FY2013 as economic growth slowed. In FY2014, the central government's liabilities are estimated to have decreased to 50.6 percent of GDP from 51.7 percent in the previous year. Combined with marginal decline in the states' debt-to-GDP ratio, general government debt is expected to fall slightly to 66.4 percent of GDP from 66.9 percent in the previous year.

## 1.6 Reform actions

**The reform momentum has accelerated.** The authorities have picked up the pace on the reform agenda while maintaining focus on efficient and effective implementation. In recent major steps, the authorities have deregulated retail diesel prices, simplified labor compliances and streamlined inspections, and announced a new mechanism for allocating coal blocks. Other important actions include steps to facilitate land acquisition and environmental clearances, strengthening financial regulations, opening defense and railways to FDI, and expanding financial inclusion.

**The Union Budget did not compromise on fiscal consolidation to support growth and committed to pushing ahead on reforms.** The new administration's first budget reaffirmed commitment to fiscal consolidation targets and announced the setting up of an Expenditure Management Commission to review public spending and propose steps to reduce subsidy expenditure (see Box 2). The authorities have also signaled a policy shift towards a reduced role for central planning, announcing the imminent dissolution of the central Planning Commission, set up in 1950, to be replaced with an economic advisory body to guide development policy thought.

**Box 2: Reform measures in Union Budget 2014-15**

The Union Budget FY2015 announced a series of steps to remove immediate growth bottlenecks and establish stronger foundations for long-term growth. Some highlights include:

- *Business environment*: All business and investment clearances on a single online portal with an integrated payment gateway by December 31; single window customs clearance.
- *Energy*: Steps to improve coal production and linkages; extension of the tax holiday on investments in power to 2017; transmission feeder separation in rural areas.
- *Infrastructure*: Formation of the National Industrial Corridor Authority and a new institution (3PIndia) to support mainstreaming of PPPs; launch of tax-favorable Infrastructure Investment Trusts; development of 16 new ports, new inland waterways, and new airports in Tier-2 cities; funds for metros in Lucknow and Ahmedabad, and additional funds for railways in border areas.
- *Cities*: Major expansion of the pooled municipal debt obligation facility for urban infrastructure and development of 100 new smart cities to ease pressure on major urban nodes.
- *Skills and access to finance*: A new "Skill-India" program to support training and building entrepreneurial skills; harmonization of know-your-customer (KYC) norms across the financial sector, and a new fund to support start-up MSME companies.
- *Agriculture*: A new program to improve access to irrigation; increasing warehousing capacity; and efforts to set up a national private agriculture market by reviewing state Agriculture Produce Marketing Committee Acts.
- *Expenditure management*: A new expenditure management commission to be set-up to review public expenditures and subsidies. The commission will submit its report within one year.
- *Environment*: Setting up of the Ganga Conservation Mission; new" ultra mega" solar power projects in four states and support to domestic solar panel/wind mill manufacturers.

**Decision making and clearance procedures for large projects have been expedited.** All Groups of Ministers and Empowered Group of Ministers that were charged with deliberating upon and taking major decisions were disbanded in May 2014, placing authority and accountability directly on the line Ministries. At the procedural level, single window clearance systems have been established to hasten large capital intensive steel, coal and power projects.

**Diesel prices have been deregulated.** In January 2013, the authorities deregulated prices of bulk diesel and permitted oil marketing companies to raise the prices of retail diesel by approximately INR0.50 per month to gradually eliminate diesel under-recoveries (i.e., the difference between the cost of production and international price). The parity between international prices and domestic cost of production was achieved in mid-September 2014, which allowed the authorities to take a critical step of deregulating retail diesel in October, thereby eliminating the largest component of the fuel subsidy burden.

**Labor reforms and skills development have taken center stage.** Regulations relating to compliance with central labor laws have been eased and made more transparent. Firms can now comply with 16 central labor regulatory requirements by filing a single return through an online portal. Further, selection of firms for compliance inspections by central labor inspectors has been made transparent- based on a random computer generated sample of registered firms. However, since labor is a concurrent subject in the Constitution, these regulatory changes are likely to have a partial impact since they only apply to enforcement agencies and industrial sectors under the purview of the central Ministry of Labor and Employment. On the legislative side, the Union Cabinet cleared amendments to The Factories Act, 1948, the Apprentices Act, 1961[21] and Labor Laws Act, 1988, for Parliamentary approval. These amendments, if they come into force, will further reduce the regulatory burden on firms, encourage apprenticeship, enhance employee safety, and reduce eligibility thresholds for receiving employee benefits. But central legislative efforts will require complementary legislative changes in state labor laws. Some states have embarked on such reforms. The Rajasthan state legislature approved similar amendments to four state labor laws while other states contemplating similar changes include Uttar Pradesh. Concurrently, skills development has been put on center stage by consolidating the different agencies and ministries dealing with the subject under the new Ministry of Skills Development, Entrepreneurship, Youth Affairs and Sports.

**Regulatory compliance costs have come down.** The Department of Industrial Policy and Promotion implemented new measures to ease the burden of regulatory compliance for businesses. The steps, listed in an advisory to all ministries, include a requirement for prior approval from department heads before inspecting any factories or business premises, shift to a system of self-certification of adherence to official norms by all companies, and maintenance of a single electronic register by all businesses.

**Land acquisition procedures could become easier**. To simplify the process of land acquisition, the Ministry of Rural Development proposed 19 amendments to the 2013 Land Acquisition, Rehabilitation and Resettlement (LARR) Act. These include (i) re-examination of the requirement of prior consent of 70 percent and 80 percent of the affected families for public-private partnerships (PPPs) and private projects respectively, (ii) restricting the need for a social impact assessment to only large or PPP projects, (iii) modification of the 'retrospective clause' which stipulates the lapse of land acquisition in case of non-payment or non-possession, and (iv) reviewing the definition of 'affected families' for resettlement benefits.

**Environmental clearances will be streamlined via legislative and executive steps**. A committee has been set up in August with a two month deadline, to review and suggest changes to major environment laws – the Environment (Protection) Act, 1986, Forest (Conservation) Act, 1980, Wildlife (Protection) Act, 1972, the Water (Prevention and Control of Pollution) Act, 1974, and the Air (Prevention and Control of Pollution) Act, 1981. At the executive level, orders have been passed to ease environment clearance for businesses: (i) the Expert Appraisal Committee, the statutory body that recommends environment clearance, has been barred from seeking additional environmental impact studies in the final (second) stage of the clearance procedure; and (ii) acquisition of land is no longer a necessary condition for initiating environmental clearance, proof of land acquisition proceedings will suffice.

**As many as 75 million poor households could gain access to bank accounts.** Over 60 percent of India's population is unbanked and a staggering 90 percent of small businesses have no linkages with formal financial institutions. The recently launched *Pradhan Mantri Jan Dhan Yojana (PMJDY)* or the people's wealth program, seeks to address these challenges by opening bank accounts for 75 million poor rural and urban families by January 2015, in public or private banks. All such accounts will be linked to a domestic debit card network, RuPay. The program is also expected to offer an accident insurance cover of up to INR0.1 million ($1650) and a INR5,000 ($83) overdraft facility once the account has been active for six months and has been linked to Aadhaar identity number. A financial literacy component is also integral to PMJDY. The program envisages covering aspects of micro insurance and pension schemes during its second phase, which will begin in 2015 and end in 2018. The RBI is expected to

[21] The Apprentices (Amendment) Bill, 2014 was approved by the parliament in August.

play the role of a key enabler and partner the government in the financial inclusion drive. Earlier this year, RBI had released guidelines for small and payment banks which will only accept deposits and handle remittances, services which are key to migrant workers, low income households, and small businesses.

**Defense and railways have become more open to FDI.** Following the proposals made in the Union Budget 2014-15, the Cabinet raised the FDI limit in defense manufacturing to 49 percent and fully opened up the railway infrastructure segment—including high-speed trains, signaling systems, electrification, manufacturing and maintenance of rolling stock—to foreign investment.

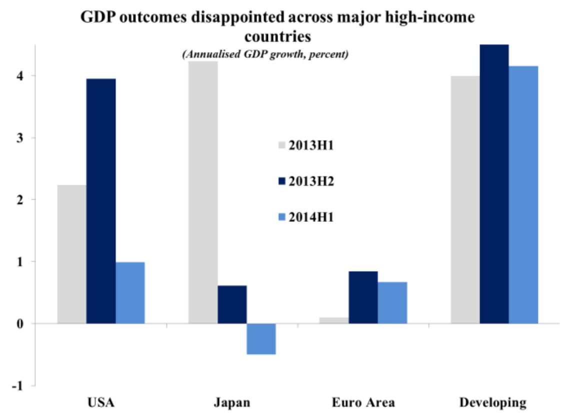
**Financial regulations have been strengthened to increase transparency and deepen financial markets.** The Parliament approved the Securities Law (Amendment) Bill, 2014 aimed at empowering the Securities and Exchange Board of India (SEBI), the financial market regulator, by expanding its jurisdiction over Collective Investment Schemes. This will allow the SEBI to call for documents, attach assets, detain entities under probe, and establish special courts to expedite cases. Mindful of pressures on the profitability of public sector banks and their need to raise INR 4–4.3 trillion of Tier I Capital between FY2015-19 to fund growth and meet Basel III norms, the RBI has recently permitted banks to issue Additional Tier I (ATI) instruments to retail investors. These instruments can potentially widen the investor base and increase investor appetite for instruments with specific loss absorption features. The principal loss absorption would be through conversion into common shares or a write-down mechanism (temporary or permanent). The RBI has also allowed banks to pay coupons on debt instruments from their distributable revenue reserves under specific circumstances, should current year profits be insufficient. In addition, the RBI raised the FII sub-limit in government bonds by US$ 5 billion after the existing US$ 20 billion limit was almost exhausted, in an attempt to stabilize yields on government securities.

**A proposed new holding structure for public sector banks could improve their performance.** To address some of the main challenges in the banking sector, the May 2014 Report on Governance of Boards of Banks in India has made key proposals to level the playing field between public and private sector banks, empower bank boards, and separate ownership and management functions.[22] The suggested holding company structure through Bank Investment Companies (BIC) for public sector banks will allow the BIC to perform a principal shareholder function while managing the risks of moral hazard, a feature that currently works against the efficient functioning of public sector banks.

## 2. Global developments

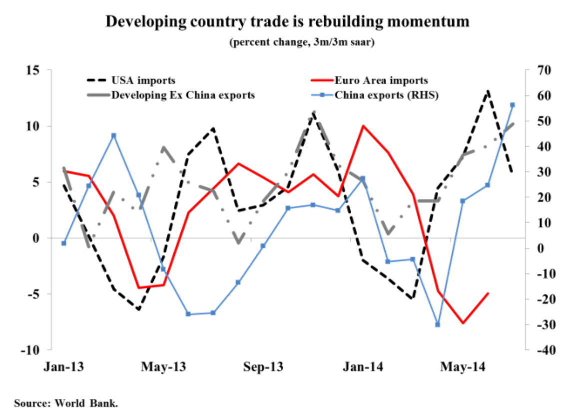
**Global growth has been weaker than expected in the first half of this year.** U.S. growth has been gathering momentum while the Euro Area and Japan appear to be stagnating. Supported by rising employment and investment growth, a still accommodative monetary policy, and easing fiscal stance, U.S. growth recovered strongly in Q2 2014 (4.6 percent saar) from a sharp contraction in Q1 (-2.1 percent saar). Meanwhile, in the Euro Area, especially in its core, growth has been markedly weaker than anticipated so far this year. Euro Area GDP was flat in Q2, following a small uptick in Q1, with the recovery momentum still impaired by weak domestic demand. In Japan, a sales tax hike in April caused volatility in quarterly activity: growth surged to 6.0 percent in Q1 reflecting a front-loading of demand, but shrank by 7.1 percent in Q1 as consumers retrenched. Among developing countries, growth in China slowed in Q1 as the authorities made efforts to rein in credit growth but renewed policy stimulus boosted growth in Q2.

[22] P J Nayak Committee Report to Review Governance of Boards of Banks in India, May 2014.



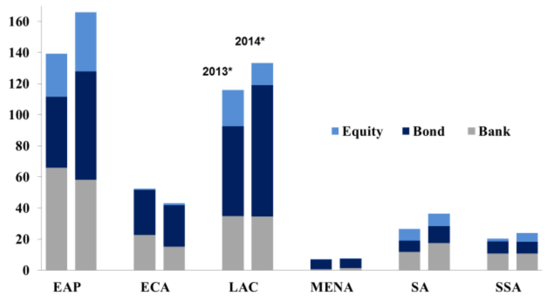

**With varied growth prospects, monetary policy challenges are also diverging in high income countries.** Markets increasingly expect the U.S. Federal Reserve's asset purchase programs to come to an end by October 2014, new guidance on monetary policy to be issued in Q4, and the first policy rate increase to occur by mid-2015. In Europe, in contrast, inflation and inflation expectations continue to trend lower. The European Central Bank (ECB) introduced a series of loosening measures in June and September, including lower interest rates and the launch of targeted refinancing operations and asset purchase programs. With these measures, the ECB plans to increase its balance sheet back to its level in 2012, an increase of about EUR800 billion. In Japan, inflation expectations are weakly anchored and loose monetary policy is projected to continue with the central bank implementing its quantitative easing as scheduled.


**Global trade has recovered in recent months but remains on a weak post-crisis trend**. Exports are growing strongly in East Asia, South Asia, and Latin America, particularly in countries with strong trading ties to the United States where import demand has improved in line with the economic recovery. In turn, industrial activity in these regions has benefitted from the stronger exports. In contrast, exports from developing Europe and Central Asia contracted in Q2 due to weakness in the Euro Area and trade restrictions associated with rising geo-political tensions surrounding Ukraine.




**Global interest rates remain exceptionally low**. Notwithstanding a weak start to the year, global equity markets have risen to all-time highs in recent months, and government bond yields have fallen to record lows. Benchmark stock indices in the United States and the United Kingdom, in particular, have risen to fresh highs on the back of strengthening macro data, still accommodative U.S. monetary policy, and expected credit easing by the ECB. The ECB's recently announced policy measures have led to a weakening of the euro against the dollar, which generated capital flows into U.S. long-term bond markets but also search-for-yield flows into riskier assets such as emerging market stock markets including India. As a result, capital flows to developing countries, which had weakened in early 2014 in a market sell-off, have resumed strongly since March and are 14 percent above 2013 levels. On a year-to-date basis, flows to South Asia (primarily India) are up by 37 percent compared to 2013, mainly reflecting strong portfolio flows (notably bonds).

Capital flows remained robust in 2014
(USD billion)



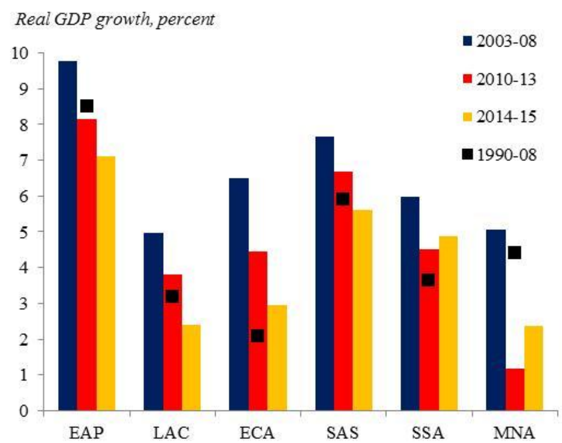

* For the first eight months of the year

**The pace of recovery varies substantially across major emerging economies.** Overall, PMI data point to further, albeit moderate, expansion in developing countries in Q3 as growth recovers from a weak start to 2014 across many emerging economies. However, performance continues to disappoint in Latin America, Russia, and South Africa. In China, stimulus measures and rising external demand are expected to deliver the authorities' growth target of 7.5 percent for the year. In Mexico, growth is picking up, with a reform-minded government boosting investors' sentiment. In contrast, Brazil is currently in recession, with growing fiscal imbalances and above-target inflation accentuating a loss of business and consumer confidence, while a deepening crisis is contributing to weakness in Argentina. In Russia, the impact of geopolitical tensions has been tempered by still high oil prices but growth is weakening and sanctions are keeping both inflation and borrowing costs high. In South Africa, growth has been held back by mining strikes so far this year and the current account deficit has widened again.

## 3. Outlook

**Global conditions are improving, with growth in high income countries expected to pick up modestly in the second half of 2014**. In the United States, the recovery is supported by strengthening domestic demand as better employment prospects support real income growth and confidence, while investment is projected to rise in line with strong profits and still favorable financing conditions. In the Euro Area, a slow improvement in credit and labor market conditions should provide some momentum ahead, but investment prospects remain subdued and precautionary savings are still high. Exports should gradually improve, supported by strengthening demand from the United States and a weakening euro. In Japan, monetary policy accommodation and reform commitments will provide ongoing support, but fiscal consolidation is expected to keep domestic demand subdued throughout 2015, with exports only recovering slowly.

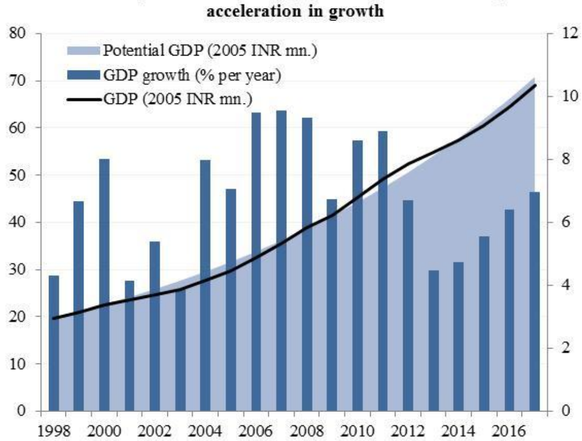
Growth in most developing regions, including South Asia, remains below long-run average




**Developing countries' growth is expected to rise modestly but remain below the pre-global crisis pace in most regions.** While the trade intensity of global growth is projected to remain below pre-crisis norms, a gradual recovery in high-income countries should provide some impetus, particularly for export-oriented economies with links to U.S. markets. Financial conditions are expected to remain benign as the continued accommodative monetary stance of the ECB could help counteract the global impact of an eventual monetary tightening in the U.S. Key commodity prices, including oil, are expected to remain stable or decline marginally.

**Growth in India is expected to improve to 5.6 percent in FY2015**. Following the improvement in Q1 FY2015, economic recovery is expected to take firmer hold during the rest of the year. Continued strengthening of the U.S. economy will support demand for India's merchandise and services exports, while remittances from Indians working abroad will raise incomes and stimulate domestic demand. Consumers and firms alike will also benefit from declining oil prices, which are expected to dip below US$100 per barrel in calendar 2015. The authorities' continued efforts to unblock investment projects, stimulate infrastructure investment and FDI, and foster a supportive policy environment are likely to contribute to investment returning to above 30 percent of GDP, after dipping below this level in FY2014. Improving investment, positive business sentiment, and strong export demand amplified by a competitive exchange rate are expected to lift manufacturing growth well into positive territory after last year's contraction. Services are also expected to continue performing well, while agricultural growth is unlikely to exceed last year's outturn of 4.7 percent due to the unfavorable base effect and deficient and untimely monsoon rains.

GDP is likely to remain below potential even with the expected acceleration in growth




**Growth is expected to strengthen further over the medium term**. Due to favorable demographics, relatively high savings, and continued efforts at improving education and skills, India's long-run growth potential remains high. The slowdown of the last few years has opened a negative output gap which would take several years to close even at growth rates well above the baseline scenario of this Update. Furthermore, the authorities reform efforts to unify India into a common market (GST), improve firms' competitiveness (labor), strengthen fiscal balances, and support investment could raise potential well above the currently estimated 6-7 percent range.[23] Under these conditions, GDP growth is expected to rise to 6.4 percent in FY2016 and accelerate further to 7.0 percent in FY2017.

**The current account deficit is expected to widen somewhat, but remain well below the average of the last few years**. The current account deficit is expected to widen from 1.7 percent of GDP in FY2015 to 2.0 percent of GDP in FY2015 as import demand rises with accelerating growth. While the maintenance of policy barriers to gold imports is likely to keep this import category compressed in the near term, imports of capital goods and intermediate inputs are likely to rise to accommodate higher investment and growing exports and domestic demand. As growth continues to accelerate in the medium term, the current account deficit is expect to widen further to 2.4-2.5 percent of GDP; this would still place the deficit well below the 3.2 percent average of the last five years and the 4.7 percent high in FY2013.

**Inflation is expected to moderate substantially in FY2015 before rebounding somewhat in the medium term**. The downward momentum in core prices of the last few months and the widening of the output gap are expected to keep core inflation muted in FY2015. Growth in fuel prices is likely to decelerate as global oil prices decline and domestic prices reach parity with international levels sometime this fall. Growth in food prices may accelerate due to the expected moderation in growth of agricultural output, but the increase will be moderated by policy decisions to keep minimum support prices for rice and pulses close to last year's levels and raise minimum export prices for onions. Overall, average WPI inflation is expected to decline to 4.3 percent in FY2015 before rebounding to slightly above 5 percent in the medium term as demand is expected to strengthen. Inflation could come down further if the RBI adopts the inflation targeting recommendations of the Patel Committee,

23 Potential growth calculated by (i) smoothing of annual and quarterly GDP series, and (ii) production function approach (see Global Economic Prospects 2014 for the latter estimates).

including a switch to the CPI as the nominal anchor and bringing inflation down to a 4 percent (+/- 2 percent) band over the medium term.

**The general government deficit is expected to decline further to 6.1 percent of GDP in FY2015**. The reiteration of a commitment to fiscal consolidation in the new Government's maiden budget, combined with a pick-up in the pace of economic activity and recently announced sales of major stakes in public sector enterprises, is expected to bring the general government deficit down from 6.8 percent of GDP in FY2014 to 6.1 percent in FY2015. Expenditure restraint will also be aided by lower spending on fuel subsidies on account of declining global oil prices and the recent deregulation of retail diesel. Over the medium term, the general government deficit is expected to decline to 5.0 percent of GDP by FY2017 as the quality of public spending improves through the work of the Expenditure Management Commission, with productive public investment taking the place of fuel, fertilizer, and food subsidies. Revenues could get a substantial boost if the federal and state authorities reach agreement on the implementation of the Goods and Services Tax (GST) which will stimulate economic activity and improve the efficiency of revenue collection (see the following section for a detailed discussion of the GST).

**Government debt is likely to remain on a sustainable trajectory**. 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. Under this Update's baseline growth, inflation, and fiscal deficit projections, the debt-to-GDP ratio is likely to rise marginally from 66.4 percent of GDP in FY2014 to 66.7 percent in FY2015. 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 Thirteenth Finance Commission, the debt-to-GDP ratio is expected to resume its earlier downward trend and fall to 63.3 percent of GDP in FY2017. 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 the primary balance or growth could have 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 government's debt-to-GDP ratio could instead rise to 72 percent of GDP by FY2017.

| Decomposition of General Government Debt | | | |
|---|---|---|---|
| (percent) | 2014/15f | 2015/16f | 2016/17f |
| **Debt-GDP Ratio (baseline)** | **66.7%** | **65.4%** | **63.3%** |
| Change in Public Debt | 0.3% | -1.3% | -2.1% |
| Identified flows | 0.2% | -1.3% | -2.1% |
| Real Interest Rate | 1.0% | 0.8% | 0.8% |
| Primary Balance | 2.7% | 1.9% | 1.4% |
| Real GDP Growth | -3.5% | -4.0% | -4.3% |
| Residual | 0.1% | 0.0% | 0.0% |
| **Effects of shocks on debt-GDP ratio** | | | |
| Fall in Real GDP growth | 69.6% | 71.2% | 71.9% |
| Fall in Inflation rate | 69.0% | 69.9% | 69.9% |
| Rise in Interest Rates | 67.1% | 66.2% | 64.4% |
| Rise in Primary B alance | 68.2% | 68.3% | 67.6% |

Normally distributed shocks (drawn from history FY2004-FY2014) were introduced to real GDP growth, inflation rate and interest rate.

One standard deviation negative shock to the primary balance (taking the reference period as FY2004-2014).

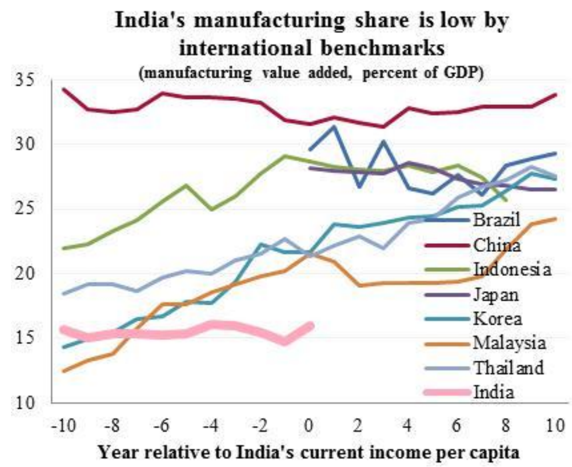
**Globally, risks are primarily on the downside.** As a group, developing countries remain vulnerable to bouts of financial market disruptions as a result of changes in monetary policy in high-income countries or weakening investor sentiment if geopolitical tensions (e.g., in Eastern Europe and the Middle East) or health concerns (e.g., from the Ebola virus in West Africa) escalate. The U.S. Federal Reserve is projected to start raising policy rates in mid-2015, which carries the risk of renewed bouts of financial market volatility, although this could be offset to some extent by recently announced ECB easing measures. Investor sentiment could also suffer if a rapid unwinding of Chinese debt leads to sharp deleveraging.

**Domestic risks could be offset, to a large extent, by continued progress on the reform agenda**. The baseline outlook in this Update is predicated on a recovery in investment, a strong pick-up in manufacturing growth, and continued progress on fiscal consolidation. Even in a favorable external environment, these outcomes could be at risk from several domestic factors. Uncertainty around the allocation of coal blocks could push up coal imports and jeopardize energy supply—a major concern since electricity is consistently ranked as a top-three constraint for manufacturing firms in India. Findings of the Seventh Central Pay Commission, the composition of which was approved by the Cabinet in February, could push up the wage expenditure once its recommendations are made available within the next 12 months. The report will guide the new structure of the salaries and pensions of more than 800,000 central government employees and retirees; the previous Pay Commission recommendations were implemented in FY08/09 (retroactive to January 1, 2006) and pushed up expenditure by 0.5 percent of GDP in that year. However, these risks could be more than offset by the potential of key reform actions (e.g., the GST, labor and regulatory reforms, energy reform, new monetary policy framework, financial inclusion) to remove many of the major binding constraints to growth in India.

## 4. Supply Chain Delays and Uncertainty

**Improving manufacturing performance in India is a necessary condition for high growth and job creation**. The manufacturing sector in India accounts for around 16 percent of GDP, a level that has remained largely unchanged in the last two decades. This is quite low relative to many comparator countries (e.g., Brazil, China, Indonesia, Korea, and Malaysia), even after controlling for differences in per capita incomes. The under-performance of the manufacturing sector in India over the last two years was a major factor in the overall growth slowdown; conversely, resumption in manufacturing growth will be necessary for India to return to high growth rates observed during the late 2000s and realize the full potential of the demographic dividend. Boosting manufacturing performance is therefore a policy priority.

**Manufacturing performance depends critically on infrastructure, where India's needs are massive.** India's infrastructure gap (i.e., infrastructure investment requirements between 2011 and 2020) is estimated at US$1.1-1.7 trillion.[24] These estimates, however, refer primarily to "hard" infrastructure like transport, electricity, water and sanitation, waste management, telecommunications, and irrigation. While the constraints arising from limited quantum and quality of "hard" supply chain infrastructure are well recognized, those that derive from limiting "soft" infrastructure factors are less well researched. "Soft" infrastructure primarily encompasses aspects of governance as well as economic and social infrastructure and is vital to the delivery of services which ride on the "hard" infrastructure.[25]




**Costs of logistics, a key component of soft infrastructure, are relatively high in India**. A recent survey of about 70 textiles, electronics, auto components, and heavy-engineering companies in India reveals that manufacturing firms incur relatively higher costs in logistics vis-à-vis the "usual suspects" like power and labor. The cost of logistics ranges from over 10 percent of net sales for auto components to over 14 percent for electronics.[26] These costs put

[24] Andres, L., D. Biller, and M. Herrera-Dappe (2013). "Infrastructure Gap in South Asia: Infrastructure Needs, Prioritization, and Financing." Washington, DC: World Bank.

[25] Economic infrastructure includes financial system and payment systems, financial regulations and monetary policy, accounting standards, etc., while social infrastructure includes educational and research systems.

[26] Auto components logistics costs could well be higher, were it not for buyer requirements of proximate location

Indian manufacturing firms in a position of major competitive disadvantage versus Indian companies in the service sector and competitors abroad, where the best-practice benchmarks for logistics costs are around 3 percent of net sales for auto components and around 4 percent for consumer durables.[27]

**High logistics costs put manufacturing firms at a disadvantage**

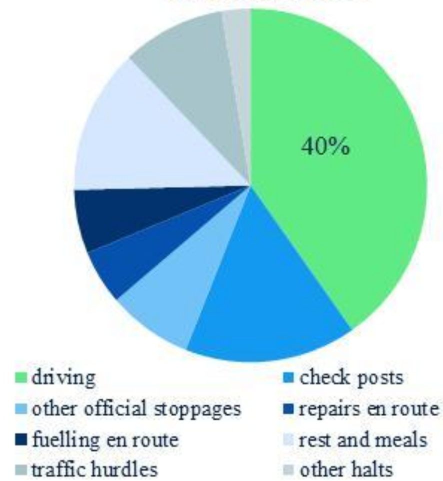
(costs as percent of net sales)

| | Compensation of employees | Power, fuel, and water | Logistics |
|---|---|---|---|
| Auto components | 7.1 | 3.7 | 10.4 |
| Textiles | 6.2 | 6.8 | 13.3 |
| Electronics | 11.8 | 1.8 | 14.1 |
| Heavy Engineering | 8.6 | 1.1 | 12.2 |
| Hotels & tourism | 24.6 | 6.9 | 0.9 |
| Telecom | 14.3 | 8.8 | 0.4 |

*Source:* Prowess.

**Most transportation in India is by truck, but "hard" road infrastructure is just one of many constraints for shipping goods.** Road traffic accounts for about 60 percent of all freight traffic in India.[28] Yet, the average speed of a truck on a highway is reported to be just 20-40 km/hour and trucks travel on average 250-300 km per day (compared to 450 km in Brazil and 800 km in the United States). Road conditions play a role in the slow pace of movement of goods, as does the generally poor condition of vehicles. Over one-third of trucks in India are more than 10 years old; as a rule of thumb, a vehicle which is less than six years old can make about 8,000 km per month while a vehicle which is more than 10 years old can make only about 2,000-4,000 km per month.[29] However, in India, as in developing most countries, high logistics costs mainly depend upon regulatory and policy implementation challenges and the market structure and organization of the trucking sector.[30]

**Only 40 percent of total trip time is spent on the road**




**Regulatory impediments increase truck travel time by a quarter.** Besides road quality, the next most frequently cited causes for freight delays are customs inefficiencies and state border check-post clearances. A number of studies in the last few years have found that for up to 60 percent of journey time, the truck is not moving.[31] Approximately 15-20 percent of the total journey time is made up of rest and meals; another around 15 percent at toll plazas; and the balance, roughly a quarter of the journey time, is spent at check posts, state borders, city entrances, and other regulatory stoppages.[32]

(see the example of Maruti Suzuki in the discussion that follows).

[27] Skill gaps in the Indian Logistics Sector- A white paper - September 2007, KPMG India

[28] Government of India, Ministry of Road Transport and Highways, Annual Report 2011-12.

[29] The relatively high age of truck fleet in India is related to the inability of small scale, unorganized and fragmented truckers, which account more than two-thirds of the industry, to replace vehicles in time.

[30] Jean-François Arvis, Gaël Raballand, and Jean-François Marteau, *The Cost of Being Landlocked: Logistics Costs and Supply Chain Reliability* (Washington, DC: The World Bank, 2010).

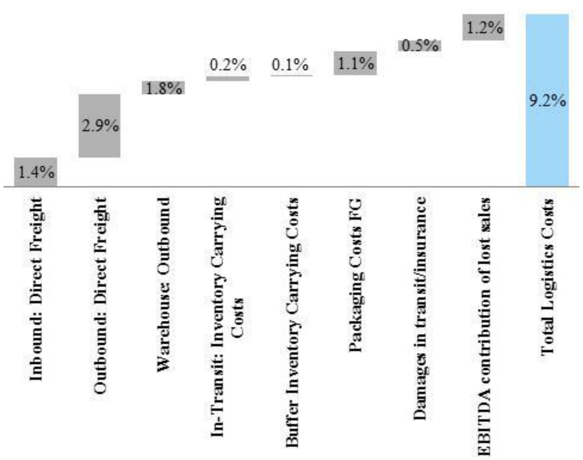
[31] "The percentage of actual moving time to the total trip time was about 69%, 54% and 38% for Mumbai-Delhi, Delhi-Kolkata and Kolkata-Chennai routes respectively," according to the survey by Rajiv Ghandhi Institute for Contemporary Studies, cited in: Ministry of Road Transport and Highways, Government of India, "Report of the Sub-group on Policy Issues," September 2011, p. 33. Another study suggested that out of total trip time, actual moving times accounted for only 33% for trips of less than 500km, 36% for 500-999km trips, and 43% for longer distances. JPS Associates, "Study on Economics of Trucking Industry," p. E-VIII.

[32] Ibid., p. 82; JPS Associates, "Study on Economic Cost of Inter-State Barriers in Goods Traffic."

**Over 650 checkpoints slow freight traffic at state borders.** The checkpoints are tasked primarily with reconciliation of central versus state sales taxes in one state with those in the other, as well as checking for road permits and associated road tax compliance, collecting and checking for other local taxes, clearances, as well as checks for and imposition of taxes on or prohibition of the movement of specific types of goods, such as alcoholic products (for state excise taxes) and mineral products (for royalties).[33] In the auto industry, the absence of any uniform specification for car carriers means different interpretations by different Regional Transport Offices (RTOs), with each state imposing different rules.[34] For example, the state of Uttar Pradesh requires trucks that pass through the state (i.e., not for delivering goods within the state but using the state roads to transit through to their destination) to declare their planned route. Reportedly, truck drivers frequently change their routes for practical reasons, such as to avoid traffic jams or congestion on the declared route. However, the fear of penalty levied for deviating from the declared route encourages truck drivers to speed with potential adverse consequences for road safety.

**The regulatory difficulties in crossing state borders have as much of an impact on freight performance as the quality of long-distance roads.** The difficulties at checkpoints can substantially impact freight routes: for example, exporters from manufacturing hubs like Tirupur and Coimbatore in Tamil Nadu report diverting their shipments by several hundred kilometers and not using the high-quality and nearby Cochin port just to avoid the Tamil Nadu-Kerala border crossing.[35] An illustrative comparison of logistics costs of three SMEs manufacturing high-value, low-volume items (alcohol products, high-end batteries, and transformers) reveals that the firm whose suppliers were almost fully based within the same state had logistics costs of 4.4 percent of sales vs. 6 percent for a firm with one major supplier from out-of-state and 9.2 percent for a firm with multiple suppliers from other states.

**Lost sales due to freight inefficiencies contribute as much as 15 percent to the already high logistics costs**




**Unpredictable variations in shipment times affect firms just as much as lengthy transit.** Except for the very few large trucking companies, which typically have established (mostly informal) links to regulatory authorities across their routes, most trucking companies cannot predict how long their trucks will be stopped en-route. This has a cascading effect on transport time, when the unpredictability of arrival times at city entrances hinders effective planning and adds further delays since all major cities have entry restrictions in place for goods vehicles. In turn, stretched lead times cause lower asset utilization (fewer trips possible in a given time) and higher in-transit inventories. Uncertainty in lead times results in the need to

[33] The commercial, excise and VAT checkpoints tend to absorb the most time in delays according to a 2003 study by Arindam Das-Gupta, "Internal Trade Barriers in India: Fiscal Check-posts," paper, August 2003. A more recent study suggests that "VAT/Commercial check-posts are the most common on-road check-posts and involve the most cumbersome and costly procedures than other check-posts barriers," JPS 2011, "Inter-State Barriers," p. 10. However, this same study shows that RTO check posts are more prevalent, and that check post halting time is primarily accounted for by RTO posts. At the same time, the incidence of defaults is much higher for commercial tax and VAT, resulting in substantial additional hours of delay.

[34] "Methodology for measuring the logistics cost for major manufacturing exports and assessing its impact on their competitiveness", FICCI, 2011

[35] Koi Yu Adolf Ng and Girish C. Gujar, "The spatial characteristics of inland transport hubs: evidences from Southern India," Journal of Transport Geography 17 (2009): 346–356.

keep higher levels of "buffer" inventory, safety stock, *or* lost sales. A survey of around 70 firms in four industries revealed that, on average, firms maintain 43 days of inventory, of which approximately 27 percent (11.6 days) is buffer stock. Worse, because firms cannot accurately plan deliveries, they may incur foregone sales penalties for non-delivery. A detailed study on three selected survey participants indicated that lost sales and additional buffer stocks to account for delays and uncertainties can account for at least 14 percent, and as much as 23 percent, of the total logistics costs.[36]

**Industries that depend critically on prompt shipping are adversely affected both in terms of costs and opportunities to grow business.** The costs of delays and lost sales are not easily quantifiable, although willingness to pay for alternate transport options is indicative. It is not rare for suppliers to pay hefty premiums for shifting to a faster, more expensive, mode of transportation.[37] More than half of the firms surveyed stated that they used premium freight providers for high priority orders, with the highest proportion (82 percent) among electronics firms. Roughly 45 percent of firms also indicated a willingness to pay a premium for on-time delivery including margin businesses like textiles and apparel. For industries that rely on refrigerated trucks, the impact of delays on the road is magnified manifold given that the refrigeration unit cannot be switched off even when the truck is waiting at a check post. Such issues have prevented the refrigerated transportation fleet from growing to required numbers. There are about 25,000 reefer vehicles involved in transportation of perishable products, of which dairy (wet milk) constitutes about 80 percent. This leaves only about 7,000 refrigerated vehicles for all other perishable categories put together, a number that is miniscule by several estimates.[38]

**Some industries have adopted rather extreme coping strategies**. In the automotive industry, the physical distribution of activities and the reaping of scale and other economies have been almost entirely subordinated to overcoming logistical difficulties. Here, the case of Maruti Suzuki is illustrative. In the early 2000s, the company relied on some 400 major suppliers located across India, with some almost 2,500km distant from its main plant in Haryana, and its total logistics costs were well above its wage bill (perhaps up to four times as high).[39] At the time, it had to carry large buffer stocks and deal with substantial freight costs. In 2013, those costs were slashed by *requiring* almost all suppliers to build, warehouse or locate within a few hours radius of the plant. Approximately 80 percent of Maruti Suzuki's suppliers are currently located within a 100km radius of the plant. The company reports that its buffer stocks are now down to zero, and it is running lean production processes. Maruti Suzuki has been able to drive this change because of the enormous scale of its operations, which make its business alone valuable enough to its suppliers to motivate them to relocate.

**India's logistics challenges extend beyond road transport to port performance and intermodal integration**. Despite a very creditable record of achievement in increasing

[36] Annex A, p. 34.

[37] Arvis et al., *The Cost of Being Landlocked*, p. 33. A detailed study in Vietnam reveals that "the root cause for costly logistics is the incidence of unpredictability that permeates supply chains. This unpredictability requires manufacturers to self-insure against uncertain freight itineraries by carrying higher levels of inventory than they would otherwise need to manage their daily operations, or face the even costlier risk of lost sales, interrupted manufacturing production runs, or a proliferation of pricey, avoidable emergency shipments." World Bank, "Taming Unpredictability as Source of Growth: What More Competitive Freight Logistics Can Do in Vietnam," summary note, 2014, p. 2; and Luis C. Blancas et al., *Efficient Logistics: A Key to Vietnam's Competitiveness* (Washington, DC: The World Bank, 2014).

[38] Ernst & Young – NCCD India joint report "Refrigerated Transportation: bottlenecks and solutions", March 2013 Another regulatory peculiarity that limits development of this important sector is that while exemption from excise duty is available for completed reefer trucks, it is not for individual components. Since reefer trucks are assembled according to specific requirements and are not sold off the shelf, it is procedurally challenging to apply these excise duty benefits. Taking advantage of these intended benefits thus leads to unavoidable and unintended cost escalation.

[39] Sumila Gulyani, "Effects of Poor Transportation on Lean Production and Industrial Clustering: Evidence from the Indian Auto Industry," *World Development 29*, no. 7 (2001), pp. 1157-1177.

both volume and performance over the last twenty years, India's ports face many challenges to their ability to meet future demand and competition from larger and more efficient ports in the region. These include: (i) ability to handle the largest vessels; (ii) transport infrastructure linkages to ports; (iii) private sector participation; (iv) port governance structures; and (v) the legal and regulatory framework in which ports operate. In particular, India's 12 major and 187 non-major ports operate within different institutional and regulatory frameworks, and all ports have been slow to embrace modernization of management structures. Meanwhile, intermodal transport is a new phenomenon in India with no underlying policy framework. For the first time inland water way authority, railways and national highways are beginning to talk about intermodal facilities, transshipment & handling yards and inland container depots linked to various modes. However, there is no policy framework to guide these discussions and to engage with businesses, state governments and other stakeholders.

**Implementation of the GST is the most crucial reform that could address today's logistics challenges.** The GST offers a unique opportunity to rationalize and re-engineer logistics networks in India, given the inherent inefficiencies with taxes based on the crossing of administrative boundaries. Under the GST, the variety of different and cascading taxes, many of them locally administered, will be replaced by a unified taxation system. This will abolish the need for reconciliation of taxes when crossing state borders, eliminate the cascading effect of the Central Sales Tax (CST), and ensure that inter-state and intra-state transactions incur the same tax liability by allowing firms to claim full credit on input purchases. The GST will free up decisions on warehousing and distribution from tax considerations so that operational and logistics efficiency determines the location and movement of goods. Freight and logistics networks will realign according to the location of production and consumption activities. This will create the hub-and-spoke models that are needed to improve freight and logistics performance.

**The transformational impact of the GST could be enhanced by a systematic dismantling of inter-state check-posts.** This would necessarily be a complex task given the multiple stakeholders involved and the perceived and potentially real revenue implications for state governments. The process of implementation requires not only the resolution of a number of issues on fiscal transfers and compensation between the central government and the states, but also putting in place sophisticated systems to efficiently handle transactions. To enable resolution of these complex issues, the purview of the ongoing consultative process for the GST roll-out among the states and between them and the central government could potentially be expanded to address other issues that cause stoppages and delays for trucks at check-posts, over and above tax collection and compliance requirements. Many of these can be addressed even in advance of the GST, and could be the object of continuing reform even once it is in place. Replicating the example of Haryana, which has entirely shifted to a mobile squad based system of monitoring and enforcement, could be considered by other states. Another promising reform that has already been undertaken by some states and may be considered for replication in others is the introduction of 'e-road permits'. These allow firms to print out permits in advance for their shipments, which allows for rapid clearing of state border and other check-posts. Finally, a roll-out of e-tolling on national highways and its extension to all state highways to eliminate waiting at tolls could further help improve logistics performance.

**Improved governance structures could also strengthen port performance and enable intermodal integration**. For ports, sectoral governance reforms could encourage competition between ports and, where volume and layout permit, between terminals within ports. This could help create a level playing field for major and non-major ports, under the purview of an independent Indian Ports regulatory body to promote and protect fair competition. Port administration could be corporatized within a legal framework and corporate charters that establish a clear commercial orientation while recognizing public interest responsibilities. Port corporations could progressively move towards the Landlord Model, adapted to their own circumstances and port development plans, but encouraging private sector investment and participation in the port's terminal activities by lease and/or concession. With regard to intermodal transport, a comprehensive intermodal surface transport policy which creates a platform for efficient and reliable freight and logistics services could be the missing link in linking investments in freight corridors, increased private sector involvement in ports, and revitalization of inland waterways.

**The potential gains of more efficient and reliable supply chains are enormous.** Simply halving the delays due to road blocks, tolls and other stoppages could cut freight times by some 20-30 percent, and logistics costs by even more, as much as 30-40 percent. This would be tantamount to a gain in competitiveness of some 3-4 percent of net sales for key manufacturing sectors, helping India return to a path of high growth and enabling large-scale job creation.

## India: Selected Economic Indicators

| | 2009/10 | 2010/11 | 2011/12 | 2012/13 | 2013/14 Est. | 2014/15 Proj. | 2015/16 Proj. | 2016/17 Proj. |
|---|---|---|---|---|---|---|---|---|
| **Real Income and Prices (% change)** | | | | | | | | |
| Real GDP (at factor cost) | 8.6 | 8.9 | 6.7 | 4.5 | 4.7 | 5.6 | 6.4 | 7.0 |
| Agriculture | 0.8 | 8.6 | 5.0 | 1.4 | 4.7 | 2.5 | 3.0 | 3.0 |
| Industry | 9.2 | 7.6 | 7.8 | 1.0 | 0.4 | 5.0 | 5.5 | 5.9 |
| *Of which*: Manufacturing | 11.3 | 8.9 | 7.4 | 1.1 | -0.7 | 4.0 | 4.5 | 5.2 |
| Services | 10.5 | 9.7 | 6.6 | 7.0 | 6.8 | 6.6 | 7.5 | 8.3 |
| Real GDP (at market prices) | 8.5 | 10.3 | 6.6 | 4.7 | 5.0 | 5.6 | 6.4 | 7.0 |
| Prices (average) | | | | | | | | |
| Wholesale Price Index | 3.8 | 9.6 | 8.9 | 7.4 | 6.0 | 4.3 | 5.4 | 5.3 |
| Consumer Price Index | 12.4 | 10.4 | 8.4 | 10.4 | 9.7 | … | … | … |
| GDP Deflator | 6.1 | 9.0 | 8.5 | 7.2 | 6.9 | 4.3 | 5.4 | 5.3 |
| **Consumption, Investment and Savings (% of GDP)** | | | | | | | | |
| Consumption 1/ | 70.7 | 70.0 | 73.6 | 74.6 | 73.6 | 72.6 | 72.3 | 71.2 |
| Public | 11.9 | 11.4 | 11.4 | 11.8 | 11.8 | 11.9 | 11.5 | 11.5 |
| Private | 58.8 | 58.5 | 62.2 | 62.8 | 61.8 | 60.7 | 60.8 | 59.7 |
| Investment 2/ | 31.7 | 30.9 | 31.8 | 30.4 | 28.4 | 29.6 | 30.2 | 31.4 |
| **External Sector** | | | | | | | | |
| Total Exports (% change in current US) | -5.8 | 37.5 | 17.9 | 0.3 | 3.9 | 7.0 | 11.2 | 13.5 |
| Goods | -3.6 | 37.5 | 23.6 | -1.1 | 3.9 | 8.5 | 12.9 | 14.7 |
| Services | -9.7 | 37.5 | 7.1 | 3.4 | 4.0 | 4.0 | 7.8 | 10.9 |
| Total Imports (% change in current US) | -0.1 | 28.8 | 24.2 | 1.1 | -6.6 | 7.9 | 11.8 | 13.8 |
| Goods | -2.6 | 26.7 | 31.1 | 0.5 | -7.2 | 8.9 | 12.2 | 13.7 |
| Services | 14.4 | 39.4 | -7.3 | 5.0 | -2.8 | 1.6 | 9.3 | 14.3 |
| Current Account Balance (% of GDP) | -2.8 | -2.7 | -4.2 | -4.7 | -1.7 | -2.0 | -2.4 | -2.5 |
| Foreign Investment (US billion) | 47.0 | 37.6 | 38.6 | 46.5 | 26.4 | 47.0 | 45.0 | 45.0 |
| Direct Investment, net | 18.0 | 9.4 | 22.1 | 19.8 | 21.6 | 22.0 | 25.0 | 25.0 |
| Portfolio Investment, net | 29.1 | 28.2 | 16.6 | 26.7 | 4.8 | 25.0 | 20.0 | 20.0 |
| Foreign Exchange Reserves (US billion) 3 | 254.7 | 274.3 | 260.1 | 259.7 | 276.4 | 321.1 | 328.6 | 342.6 |
| **General Government Finances (% of GDP)** | | | | | | | | |
| Revenue 4/ | 18.6 | 20.2 | 18.6 | 19.5 | 19.9 | 20.0 | 20.8 | 22.0 |
| Expenditure | 28.0 | 27.1 | 26.2 | 26.6 | 26.6 | 26.1 | 26.5 | 27.0 |
| Deficit | 9.4 | 6.9 | 7.6 | 7.1 | 6.8 | 6.1 | 5.7 | 5.0 |
| Total Debt 5/ | 72.5 | 67.4 | 67.0 | 66.9 | 66.4 | 66.7 | 65.4 | 63.3 |

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

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