



Report and Recommendation of the President to the Board of Directors

Project Number: 41930
September 2009

Proposed Loan and Technical Assistance Small and Medium Enterprise Trade Finance Development Facility (India)

In accordance with ADB's public communications policy (PCP, 2005), this abbreviated version of the RRP excludes confidential information and ADB's assessment of project or transaction risk as well as other information referred to in paragraph 126 of the PCP.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 9 September 2009)

Currency Unit	=	Indian rupee/s (Re/Rs)
Re1.00	=	\$0.0206
\$1.00	=	Rs48.46

ABBREVIATIONS

ADB	–	Asian Development Bank
ASEAN	–	Association of Southeast Asian Nations
BIMSTEC	–	Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation
ESMS	–	environmental and social management system
Exim Bank	–	Export-Import Bank of India
FDI	–	foreign direct investment
FY	–	fiscal year
GDP	–	gross domestic product
KfW	–	KfW Bankengruppe
LDC	–	least developed country
MERCOSUR	–	Mercado Común del Sur (Common Market of the South)
MSMEs	–	micro, small, and medium enterprises
PRC	–	People's Republic of China
RBI	–	Reserve Bank of India
SAARC	–	South Asian Association for Regional Cooperation
SAFTA	–	South Asia Free Trade Area
SIDBI	–	Small Industries Development Bank of India
SMEs	–	small and medium enterprises
SSI	–	small-scale industry
TA	–	technical assistance
WTO	–	World Trade Organization

NOTES

- (i) The fiscal year (FY) of the Export-Import Bank of India and the Government of India begins on 1 April and ends on 31 March. "FY" before a calendar year denotes the year in which the fiscal year ends, e.g., FY2010 begins on 1 April 2009 and ends on 31 March 2010.
- (ii) In this report, "\$" refers to US dollars.

Vice-President	X. Zhao, Operations 1
Director General	K. Senga, South Asia Department (SARD)
Director	A. Sharma, Financial Sector, Public Management, and Trade Division, SARD
Team leaders	C. Kim, Principal Financial Sector Specialist, SARD H. P. Brunner, Senior Economist (Trade), SARD
Team members	P. Bailet, Counsel, Office of the General Counsel P. Marro, Senior Investment Specialist, SARD B. Raemaekers, Guarantees and Syndications Specialist, Office of Cofinancing Operations V. Rao, Finance Specialist (Public–Private Partnership), SARD J. Romero-Torres, Financial Specialist, SARD

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LOAN AND TECHNICAL ASSISTANCE SUMMARY

Borrower	<p>Export-Import Bank of India (Exim Bank)</p> <p>Created under an act of Parliament, Exim Bank supports India's foreign trade. Exim Bank's performance highlights its commercial orientation and the independence of its board and management, which enables the bank to carry out its mandate. Exim Bank has maintained moderate profitability. The adverse impact of tightening net interest margins over the last 4 years was effectively mitigated by the bank's management through a low and further improving cost-income ratio and a sharply improving loan portfolio, which kept noninterest costs well in check. Exim Bank is now uniquely well positioned as a small and medium enterprise (SME) export catalyst in a tightening long-term export finance market.</p>
Classification	<p>Targeting classification: Targeted intervention—geographic (Assam, Madhya Pradesh, Orissa, Uttar Pradesh)</p> <p>Sector (subsectors): Finance (SME finance and leasing, trade finance)</p> <p>Themes (subthemes): Economic growth (promoting economic efficiency and enabling business environment, widening access to markets and economic opportunities), regional cooperation and integration (trade and investments), private sector development (private sector investment)</p> <p>Location impact: Rural (high impact), urban (medium impact); national (high impact), regional (low impact)</p> <p>Partnership: KfW Bankengruppe</p>
Environmental and Social Safeguards	<p>Environment: Category FI</p> <p>Indigenous peoples: Category C</p> <p>Involuntary resettlement: Category C</p>
Rationale	<p>International experience suggests that trade openness has a strong positive association with per capita income and poverty reduction, also the main focus of the global Aid for Trade initiative of the World Trade Organization (WTO). However, trade itself depends on global income growth. In a contracting economy, a 1% decline in world income leads to at least a 3% decline in trade. A 1% decline in the share of trade in gross domestic product would increase the country's poverty rate by 0.6%. With growth becoming more Asia-driven, India must invest now in structure adjustments to global, regional, and domestic shifts in market preferences. To reverse declines in India's trade volume in late 2008 and early 2009, India has made the expansion of market share and employment and income generation in its poorest regions key objectives of its foreign trade policy. The pace of technological change, the intensity of international competition, and the ongoing dispersion and interpenetration of productive activity along production chains in Asia have convinced policy makers and entrepreneurs alike that participation in regional value chains and production clusters and networks is the key to</p>

economic growth. Local SMEs in disadvantaged and poor regions with difficult access to markets must acquire greater competitive capacity to participate in the value chains. Although India's trade has already diversified from the classic south–north axis through the relative expansion of south–south trade and intraregional trade with South and Southeast Asia, its income growth and employment potential still has to be exploited. Exim Bank is a catalyst for such structure adjustment to the new, emerging trade environment.

In the emerging export markets, with their legal, regulatory, and political risks, government-supported trade finance institutions like Exim Bank have been effective sources of finance for areas where the financial markets have stayed underdeveloped because of unfavorable perceptions of risk. While the market can normally provide short-term trade finance for developed countries, long-term debt financing in India—in particular for export markets in emerging economies—is inadequate, as the Government and the financial sector well recognize. Most commercial banks concentrate on short-term lending, particularly to the fast-growing consumer finance sector, and are typically unwilling to fund long-term trade finance instruments, also called export finance instruments, from (short-term) deposits. Even with a limited share in export finance, specialized institutions like Exim Bank should encourage longer-term commercial trade financing for SMEs in emerging markets, in support of India's efforts to expand south–south trade.

The Facility

The facility consists of (i) a loan of up to \$100,000,000 (denominated in US dollars), and (ii) a technical assistance grant of up to \$1,550,000 from Asian Development Bank's (ADB's) Technical Assistance Special Fund (TASF-other sources). The loan, without government guarantee, will be supported by a partial credit guarantee from German development cooperation through KfW Bankengruppe (KfW) through a risk participation agreement. The loan will have a tenor of up to 7 years, with a grace period of 3 years, and will be repaid semi-annually.

ADB will charge an interest rate, and commitment and front-end fees to be determined by ADB's Investment Committee.

Given the high growth of the medium- and long-term trade loans of Exim Bank, the proposed facility will fund the long-term foreign exchange business segment. The facility will be a strategic partnership, with Exim Bank assurances of increased trade within Asia and greater competitiveness among India's SME exporters from lagging states—Assam, Madhya Pradesh, Orissa, and Uttar Pradesh—to generate employment and income.

Technical Assistance

The technical assistance, a critical component of the facility, will support Exim Bank in drafting and implementing a strategy for strengthening its role as the lead trade development agency in the region. Critical, monitorable parameters are (i) target SME export

markets, especially in developing countries where India is well positioned; (ii) the financing needs and risks of global value chains and SME production clusters originating from India; (iii) the suitability of Exim Bank products; (iv) the implementation of international best practices in environmental and social safeguards; and (v) products developed to leverage resources through structured financing involving the structuring of risk layers to be borne by the Government (first loss, junior debt), Exim Bank (mezzanine debt), and private finance (senior debt), as well as the phasing in of Basel II principles.

Justification for ADB Facility

The financing will help India meet its trade objectives, which are essential for economic growth, employment, and poverty reduction. International experience suggests a strong association between trade openness and the individual incomes of citizens, pointing to the substantial trickle-down effects generated through the producer value chain to small manufacturing businesses and agricultural producers. Long-term finance is needed to develop cross-border trade capacity. The facility can be expected to employ 50,000 or more people in strengthened SME export clusters, with an incremental trade volume of \$1 billion or more over 10 years. Government support for export finance is particularly important for trade with emerging markets, where perceptions of higher legal, regulatory, and political risk hamper the growth of the financial markets.

The proposed nonsovereign loan to Exim Bank is aligned with the vision and strategic agenda of ADB expressed in Strategy 2020. It is also consistent with ADB policy to provide financial assistance without government guarantee to public sector enterprises that have adequate autonomy and managerial skills. As outlined in *Innovation and Efficiency Initiative Pilot Financing Instruments and Modalities* (2005), creditworthy state-owned enterprises are potential ADB clients, eligible for direct borrowing independent of sovereign exposure. While commercially oriented, these entities create employment and support economic growth and income generation. Exim Bank fits the eligibility criteria for ADB's nonsovereign financing facility because of its (i) role in opening the market for medium- to long-term export finance to emerging markets and to SMEs, especially in poor and lagging states; (ii) independent and commercially oriented management; (iii) sufficient depth of experience in international export finance; and (iv) strong balance sheet, cost efficiency, and good portfolio quality. In addition, by encouraging the participation of development partners, ADB is increasing the volume of market-based financing for Aid for Trade. Under the proposed nonsovereign loan agreement, Exim Bank will give its assurance that the SME export growth, employment, and SME cluster output targets specified in the design and monitoring framework will be achieved.

The facility will contribute in a major way to Exim Bank's institutional development into a modern trade financier that can leverage other commercial resources into new markets, apply prudent Basel II risk

management principles, and implement an environmental and social safeguard policy that allows exporter clients to maintain and improve their competitiveness and creditworthiness amid rising awareness of environmental and social safeguards and other product quality standards in international trade.

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed loan of up to \$100,000,000 (denominated in US Dollars), without government guarantee, supported by a partial credit guarantee from German development cooperation through KfW Bankengruppe (KfW); and (ii) a proposed technical assistance (TA) grant of up to \$1,550,000 both to Export-Import Bank of India (Exim Bank) for the Small and Medium Enterprise Trade Finance Development Facility. The design and monitoring framework is in Appendix 1.

II. RATIONALE: SECTOR PERFORMANCE, CHALLENGES, AND OPPORTUNITIES

A. Sector Characteristics and Performance

2. **Positive association of trade, per capita income, and poverty reduction.** A 1% increase in the share of trade in gross domestic product (GDP) is estimated to decrease a country's poverty rate by 0.6%.¹ Trade openness and the increase in income and decrease in poverty are strongly associated, pointing to large trickle-down effects to small business, employment, and income through the manufacturing value chain. India remains a small participant in global production networks, with only a 7% share of parts and components in total manufacturing exports.² Since fiscal year (FY) 2000, the dollar value of India's labor-intensive exports of agricultural produce have surged by 14% yearly, and manufactured goods by 24%, indicating the initial integration of rural areas and farmers, as well as small and medium enterprises (SMEs), into the global value chain. Experienced corporate exporters have, however, not yet established large supply networks with small businesses and farmers in rural India; thus, trade has so far not been fully effective in reducing poverty in the rural areas, especially in the backward and poorer regions of India. This conclusion is consistent with the findings of an ADB report (footnote 2) and of the G8,³ the G24,⁴ and the World Trade Organization substantiating the Aid for Trade initiative.⁵ In view of the present adverse global economic environment for trade, and India's projected loss of up to 10 growth points in the next 2 years as a result of the 2009 fall in export volumes, adaptation investment is needed to avert overly negative income and poverty effects.

3. The Aid for Trade support, however, is expected to overcome in the medium to long term the market and governance failures that prevent SME market entry and linkages especially in poorer regions. Aid for Trade support and investment, for instance, (i) increases the management and technical capacity of exporters, (ii) facilitates technology transfer and use of quality standards, (iii) strengthens the business environment within a more-robust regulatory and administrative structure, and (iv) improves trade-related infrastructure. Details on how Aid for Trade overcomes market and governance failures are given in Appendix 2, Table A.2.13.

¹ United Nations Economic and Social Commission for Asia and the Pacific, ADB, and United Nations Development Programme. 2008. *A Future Within Reach 2008: Regional Partnerships for the Millennium Development Goals in Asia and the Pacific*. Bangkok.

² Jongwanich, J., W. James, P. Minor, and A. Greenbaum. 2009. Trade Structure and the Transmission of Economic Distress in the High-Income OECD Countries to Developing Asia. *Asian Development Review*. 26 (1). Manila: Asian Development Bank.

³ The Group of Eight (G8) is an international forum for the governments of Canada, France, Germany, Italy, Japan, the Russian Federation, the United Kingdom, and the United States.

⁴ The Group of 24 (G24), a chapter of the Group of 77 (G77), was established in 1971 to coordinate the positions of developing countries on international monetary and development finance issues. The G77 is a coalition of developing nations promoting its members' economic interests and negotiating capacity in the United Nations.

⁵ WTO. 2006. *Aid for Trade*. <http://www.wto.org>; WTO. 2007. *Boosting Trade Finance in Developing Countries*. Geneva. http://www.wto.org/english/res_e/reser_e/ersd200704_e.pdf

The proposed Small and Medium Enterprise Trade Finance Development Facility is thus aimed at medium- to long-term development, and complements short-term trade finance from commercial banks for pre-shipment and post-shipment of import and export goods.⁶

4. Export development cluster and “poverty-intensive” cluster development initiative. The Eleventh Five Year Plan 2007–2012 (11th plan) of the Government of India highlights the importance of the cluster development initiative to the integration of backward and lagging regions with export markets.⁷ Improvements will be made in the competitiveness of over 400 manufacturing and over 6,000 lower-technology SME “poverty-intensive” clusters, with consequent employment, income growth, and poverty reduction benefits. The highest SME export development priority is assigned to clusters in lagging regions and states, which account for only for a small share of established clusters. SMEs often act as ancillaries (indirect exporters) for the large-scale producers, central distributors, and lead firms along value chains, providing them with vital components and backward linkages. So far, these SMEs are excluded from modern value chains. Exim Bank has been designated by the Government as the lead agency for the promotion of export-oriented SMEs and of lower-technology SME “poverty-intensive” clusters. In FY2008, Exim Bank facilitated SME exports of Alphonso mangoes to Singapore, and seedless grapes to Dubai and the Bhagva variety of pomegranates to Dubai. Through investments in trade infrastructure, technology, and long-term capacity building, Exim Bank also brought SMEs from various clusters into the global value chain of the world’s second-largest retailer operating stores in Asia, Europe, and Latin America, for the export of home decor items, leather photo frames, and lacquered jewelry boxes. Under the proposed nonsovereign loan agreement, Exim Bank will give its assurance that the SME export growth, employment, and SME cluster output targets specified in the design and monitoring framework (Appendix 1) will be achieved.

1. Economic Reforms

5. India’s trade policy. An outward-looking and liberal trade policy is one of the main features of India’s economic reforms. India intends to stimulate growth in trade, exploit its labor advantage, and broaden the benefits from trade growth with more-inclusive growth. Recognizing the opportunities and challenges of integration in an increasingly globalized world economy, India, under its *Foreign Trade Policy 2004–2009*, looks forward to doubling its share in world trade to 2% and generating more employment by promoting labor-intensive exports. India’s trade strategy has set its sights on (i) rationalizing tariffs and tax rebates, and reducing transaction costs; (ii) producing better-quality and more-reliable exports; (iii) upgrading export infrastructure; and (iv) improving medium- to long-term trade finance (export finance). See Appendix 2 for details on the trade sector.

6. Economic and structural reforms. India has undertaken various economic and structural reforms following the balance-of-payments crisis in 1991 and the realization that a high degree of protection meant low economic growth and low income for the citizens. These reforms have

- (i) facilitated foreign direct investment;
- (ii) encouraged the privatization of nonstrategic state-owned enterprises;

⁶ ADB. 2009. *Major Change in Scope and Amount: Trade Finance Facilitation Program*. Manila. The focus of the program is on less-developed countries—Afghanistan, Azerbaijan, Bangladesh, Cambodia, Mongolia, Nepal, Pakistan, Sri Lanka, Tajikistan, and Viet Nam, among others.

⁷ Planning Commission, Government of India. 2008. *Eleventh Five Year Plan, 2007–2012*. Delhi.

- (iii) developed capital market infrastructure for the corporate bond and equity markets;
- (iv) improved prudential regulation and supervision of the banking sector through the Reserve Bank of India (RBI);
- (v) effectively deregulated interest rates by 1997, except for rates on the smallest loans;
- (vi) paved the way for the entry of private and foreign banks (the 19 new private and 31 foreign banks and the private sector now hold 26% of banking assets); and
- (vii) introduced measures to align financial practices with international standards (Basel II).

7. The reforms not only improved the financial sector but also opened up India's markets by reducing government controls on foreign trade and investment, thereby improving the country's position in the global market.

8. **Money laundering and financing of terrorism.** RBI created the Committee on Bank Frauds in 1999 and Parliament passed the Prevention of Money Laundering Act in July 2002, putting in place procedures, systems, and controls to help combat money laundering. RBI issued "know your customer" guidelines and instructed banks to monitor suspicious cash transactions and to report transactions of terrorist entities or of individuals or organizations suspected of fronting for terrorist entities. Legal reforms include the passage of security laws and amendments to the Negotiable Instruments Act. RBI has also proposed comprehensive amendments to the RBI Act (1934) and the Banking Regulation Act (1949). In addition, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (2002) regulates the securitization and restructuring of financial assets, and enforces debt security to improve creditor rights and reduce nonperforming loans.

2. Results of Reforms

9. **High-growth trajectory.** The Indian economy, particularly the trade sector, has benefited significantly from global trends and the reforms pursued by the Government. India's share in world exports increased marginally from about 0.7% in 2001 to 1.8% in 2006, and is hewing to the target of close to 2% for 2009, despite the adverse global economic environment. Export volume tripled from 2001 to 2006, growing by 22% yearly on average, and imports grew by 28% yearly, to more than four times the volume in 2001. Service exports, especially in information technology, biotechnology, call centers, and other administrative outsourcing, increased by an annual average of 34%, while service imports during the same period grew by an annual average of 22%. The dramatic surge in India's openness, especially up to 2008, is shown in Table 1. The ratio of merchandise exports to GDP increased from 5.8% in FY1991 to 15.5% in FY2008, while the ratio of imports to GDP increased from 8.8% to 23.5%. India's export growth (by volume) during the period, led by a surge in manufactured exports, was also higher than the world average. However, because of infrastructure and political constraints, the trade value chains within India have not yet tapped the poorer regions and lagging states or integrated them into the global economy. The vast potential of these regions for increased trade is recognized.

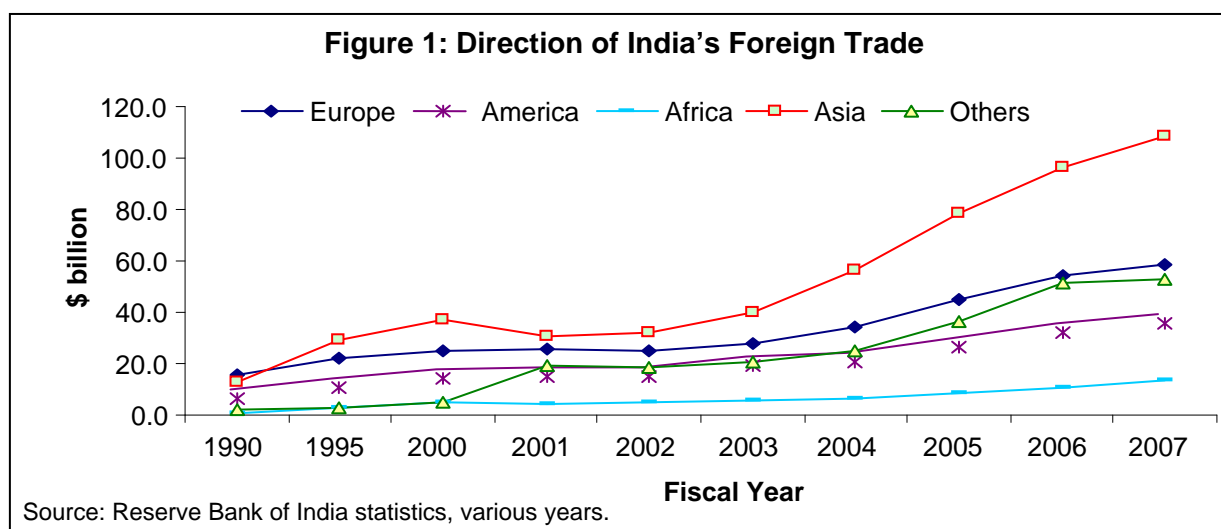
Table 1: India's Openness to the World Economy, 1990–2009
(% of GDP)

Item	1990–1991	1995–1996	2000–2001	2005–2006	2007–2008	2008–2009
Merchandise Trade	15	22	23	33	39	36
Trade in Goods and Services	17	26	29	45	48	46
Gross Capital Transactions	12	13	22	32	44	—

— = not applicable, GDP = gross domestic product.

Source: Reserve Bank of India, *Report on Currency and Finance*, various years.

10. **Diversification to south–south trade.** Although the United States is still India's largest trade partner, its importance is declining even as other Asian and even African countries are gaining ground. Since FY2001, the United States' share in India's trade has declined from 13% to 9.7%, while the PRC's share has increased from 2.5% to 7.7%. The share of the European Union has decreased from 22% to 18.72%, while that of other Asian countries including the Pacific has increased from 32.9% to 56%. Trade with the United States and Europe will remain very significant, but it will grow more slowly compared with trade with new markets. India recently identified opportunities for trade with other countries in South Asia and with the Association of Southeast Asian Nations (ASEAN), East Asia, and Africa. Figure 1 shows the recent impressive growth in India's trade, especially in Asia. This is indicative of the increasing importance of India in global value chains that connect Asia to North America and Europe. The country must also diversify into various product value chains to tap the trade potential of poor and lagging regions. Studies show that backward regions can develop and sustain such value chains as bamboo flooring, organic pineapple, natural rubber and rubber products, and tourism, all of which have substantial potential for global trade.



B. Overview of the Small and Medium Enterprise Sector

1. Definition of Small and Medium Enterprises and Export-Oriented Unit

11. India has developed definitions for enterprises in various size groups. SMEs, in the 11th plan, are small and medium enterprises, closely along the lines of international practice; MSMEs

are micro, small, and medium enterprises; and MSEs are micro and small enterprises.⁸ These definitions have superseded the older notion of small-scale industries (SSIs), first introduced in India by the Industries (Development and Regulation) Act of 1951 (the IDR Act). The IDR Act, which has been amended several times over the years, defines SSIs in terms of investment limits in plant and machinery, excluding land and buildings. An SSI unit is now defined as an industrial undertaking that invests up to Rs10 million (\$0.25 million) in plant and machinery, excluding land and buildings, whether on ownership terms or on hire-purchase.⁹ The Government has increased the SSI investment limit to Rs50 million (\$1.23 million) in respect of certain specified items under hosiery, hand tools, drugs and pharmaceuticals, and sporting goods. However, medium enterprises were defined only in May 2006. The Micro, Small and Medium Enterprises Development Bill (MSME Bill) of 2006 classifies medium enterprises as entities that invest no more than Rs100 million (\$2.45 million) in plant and machinery, excluding land and buildings. Service sectors have different limits (Table 2). For effective MSME development, the Government amended the Government (Allocation of Business) Rules of 1961 on 9 May 2007, merging the Ministry of Agro and Rural Industries and the Ministry of Small-Scale Industries into a single ministry—the Ministry of Micro, Small and Medium Enterprises.

Table 2: Classification of Enterprises into Different Categories (New Definitions)

Classification	Fixed Assets Investment Ceiling (excluding land and building)	
	Manufacturing	Service
Micro	Up to Rs2,500,000	Up to Rs1,000,000
Small	Rs2,500,000 to Rs50,000,000	Rs1,000,000 to Rs20,000,000
Medium	Rs50,000,000 to 10,000,000	Rs20,000,000 to Rs50,000,000

Source: Biswas, Indranil, and Milindo Chakrabarty. 2008. *Can Indian Micro Small and Medium Enterprises (MSME) Sustain Globalization with the Present Technology Mix? A Disaggregated Study According to Sources of Technological Know-How*. <http://ssrn.com/abstract=1284892> (accessed 15 October 2008).

12. As for export-oriented units, these are SSIs that export more than 50% of their output. To enable these units to meet the pricing, quality, and precision requirements of foreign markets, the Government amended its concession scheme in November 1983 and introduced the concept of 100% export-oriented units. According to this scheme, a 100% export-oriented unit is an industrial unit that offers to export its entire production, excluding permitted sales in the domestic tariff area, and that may have up to 100% foreign equity participation with certain conditions.¹⁰ A 100% export-oriented unit is also exempted from paying corporate tax for 5 straight years in its first 8 years of operation, and is entitled to benefits including a special import license, as well as an additional special import license of 2% of the free-on-board value of exports.

⁸ The definition of SMEs differs between countries. SMEs have been defined against various criteria such as the number of workers employed, the volume of output or sales, the value of assets employed, and the use of energy. SMEs, for the Organisation for Economic Co-operation and Development (OECD), are entities with no more than 500 employees. For the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group, SMEs employ up to 300 and have annual sales of less than \$15 million. For the European Union, SMEs employ no more than 250 and their annual turnover does not exceed €50 million (\$70 million).

⁹ Small-scale units that invest up to Rs2.5 million in plant and machinery are classified as tiny (or micro) enterprises.

¹⁰ Regarding their export obligations, 100% export-oriented units, among other conditions, (i) need not export their manufactured goods themselves but may use an export house or trading house, (ii) must execute a bond or legal undertaking with the development commissioner concerned, (iii) must adhere to the minimum value-addition conditions (in general, at least 35% value addition for automatic approvals) stated in the letter of permission or industrial license issued to them, and (iv) must keep proper records of their imports, consumption and use of imported materials, and exports.

2. Overall Performance and Export Contribution of the Small and Medium Enterprise Sector

13. According to the 11th plan, the country's 12.8 million SMEs employed about 30 million people in 2006/2007, and MSMEs employed about 65 million, or about 70% of formal employment in India.¹¹ The sector manufactures more than 8,000 diverse products, valued currently at almost Rs8,160 billion and contributing around 40% of industrial production and 50% (35% direct and 15% indirect) of India's exports. Thus, SMEs are an important instrument of inclusive growth in India, and touch on the lives of the most vulnerable, including women, scheduled tribes, and women and children living in urban slums and in remote villages. The SSI sector has a significant role in balanced and sustainable economic growth, employment generation, entrepreneurial skills development, and export earnings. The target growth rate for SMEs under the 11th plan is 12%, 2–3 percentage points higher than the target growth rate for the entire industries sector.

14. The comparative advantage of small firms lies in their greater share of value added from labor—especially semiskilled and skilled labor, and, in the Indian context, even unskilled labor (without completely overcoming disguised unemployment). MSMEs employ 1.39 employees per unit of investment, compared with 0.2 employees for the same unit of investment in large industries (Table 3 reference). Besides, manufacturing is the most tradable of all sectors, especially when the goods meet international quality standards, are competitive, and have long shelf lives. Successful industrializing economies (especially late industrializers and densely populated industrializing economies) show the crucial role of labor-intensive manufacturing in the transformation of the economy. The reason is easy to see: the social price of labor is technically zero when this factor is in surplus. Since small firms have competitive advantage in labor-intensive manufacturing, significant export promotion initiatives are clearly impossible without small firms in a dominant role. Small firms also complement large firms through supply-chain relationships and subcontracting.

3. Small and Medium Enterprise Clusters for the Inclusion of Poor States and Lagging Regions

15. The 11th plan of the Government highlights the importance of the cluster development initiative to the integration of backward and lagging regions with export markets. Over 400 manufacturing and over 6,000 lower-technology SME “poverty-intensive” clusters will undergo improvements in competitiveness, with consequent benefits to employment, income growth, and poverty reduction. Clusters in the lagging regions and states of India, which account only for a small share of established clusters, have the highest priority in SME export development. Table 3 shows that Eastern India has only 9% of manufacturing clusters, and that the poor states have none. The East and the poor states are similarly underrepresented when it comes to MSME clusters. Hence, the Government views financing and capacity building of SMEs in these lagging regions as important for their inclusion in global trade links.

¹¹ Department of Scientific and Industrial Research, Ministry of Science and Technology, Government of India. 2009. *Searchable Database for Exportable Technologies from SMEs of Tamil Nadu and Kerala*. <http://dsir.nic.in/reports/ExpTechTNKL/Abs%20new/1INTRODUCTION.htm>

Table 3: Indian Small and Medium Enterprises Clusters, by Region
(%)

Region	Traditional Manufacturing	Micro, Small, and Medium Enterprises		
		Handicrafts	Handlooms	Others
North	31.7	25.7	23.6	24.1
East	9.3	23.2	7.2	16.0
West	36.1	27.5	22.6	27.2
South	22.9	18.1	36.0	29.6
Poor states	0.0	5.5	10.6	3.1
Total	100.0	100.0	100.0	100.0

Source: Compiled from the Directorate of Handicraft and Handlooms; the United Nations Industrial Development Organization; and the third census of SSI units, 2001–2002.

4. Financing for Small and Medium Enterprises

16. At the end of FY2007, only about 8% of bank lending was going to SSIs. In FY2005, SSIs derived 73% of their financing from public sector banks (Rs676 billion, Rs27.7 billion of this from the Small Industries Development Bank of India [SIDBI] through its indirect assistance scheme). Table 4 gives a snapshot of the total credit outstanding to the SSI sector.

Table 4: Total Credit Outstanding to the Small-Scale Industry Sector
(Rs billion)

Item	FY2003	FY2004	FY2005
Public Sector Banks	529.88	583.11	676.34
Indian Private Banks	68.57	75.90	86.68
Foreign Banks	40.10	53.07	69.14
SIDBI	19.50	91.22	100.84
Total	658.05	803.30	933.00

FY = fiscal year, SIDBI = Small Industries Development Bank of India.

Source: Small Industries Development Bank of India.

17. As of March 2006, outstanding credit to the SSI sector totaled more than Rs1,000 billion (\$25 billion). Banks have been the major source of credit for the sector (both SSI and medium enterprises) over the years. However, since nonperforming assets in the SSI segment are highest for banks, the proportion of SSI loans to net bank credit has been declining, from 15% in 2003 to about 8% in 2006.

5. Policies to Stimulate the Flow of Credit to Small and Medium Enterprises

18. SMEs need working capital and term loans.¹² Realizing the credit needs of the SSI sector, the Government has devised policies to increase the flow of credit to SMEs under priority sector lending programs. These policies require banks to direct a defined percentage (currently 40%) of their overall lending to priority sectors identified by the Government. Agriculture, small industries, and exports are priority sectors under these policies.

19. Several committees have been formed to help ease the flow of credit to the SSI sector. The Nayak committee set up by RBI dealt with the adequacy and timeliness of credit to SSIs. The committee estimated SSI working capital at 8.1% (FY2005 and FY2006) of annual output, far below the normal requirement of 20%, and recommended that working capital for the SSI

¹² Credit becomes even more critical when a large-volume order is placed, a consignment is rejected, payment is inordinately delayed, or some other episodic event occurs.

sector be made equivalent to 20% of annual projected turnover.¹³ The Ganguly committee assessed the progress made in the implementation of the recommendations of the Kapur and Gupta committees and emphasized the need for credit intermediaries dedicated to SME and trade financing. Such credit intermediaries would absorb credit risk and extend quick credit to SME clusters, including export clusters, accredited to them.¹⁴

20. As recommended by these committees, the Government undertook several initiatives including uncoupling SIDBI from Industrial Development Bank of India, opening specialized branches for SME lending,¹⁵ increasing the limits of composite loans from Rs0.2 million to Rs0.5 million, setting up debt recovery tribunals, introducing a credit guarantee scheme, and raising the exemption limit for collateral security from Rs25,000 to Rs0.5 million. Further, the internal group formed by RBI to review the guidelines for SME credit to the SME sector recommended that commercial banks set their own lending targets for the sector, with disbursements increasing yearly. The internal group also recommended the continuation of sub-targets for the financing of tiny units (up to 40%) and smaller units (20%). The finance minister, in a statement in the Rajya Sabha (upper house of Parliament) on 10 August 2005, proposed the implementation of the recommendations of the internal group. He fixed a 20% minimum growth in credit to SME sector to double the flow of credit to the sector from Rs676 billion in FY2004–FY2005 to Rs1,350 billion by FY2009–FY2010. However, as already mentioned, SMEs at the end of FY2007 were attracting only 8.1% of bank credit. On 6 June 2007, a group under an executive director of Exim Bank and comprising representatives from the Government's Department of Commerce, commercial banks, SIDBI, trade bodies, and three departments in RBI was created to assess the credit needs of MSME exporters. After extensive deliberations, the group recommended that 50% of export credit be earmarked for the MSME sector by all banks including foreign banks. Banks with a lower MSME portfolio in their total export credit portfolio could be given a specific period by RBI, depending on each case, to achieve the proposed lending. RBI has since forwarded the report to the Government and will issue suitable guidelines once the Government gives its approval. Appendix 2 discusses the evolution of the Government's policies and trade reforms to promote SME growth and credit flow. Such policies and reforms have assumed utmost significance in the difficult global economic environment at present.

C. Challenges and Opportunities

1. Severe Deceleration in Trade Growth

21. As a consequence of the global economic crisis, the Government is challenged to intensify structural economic reforms and to improve the export performance especially of the SME segment of the economy. The Government now gives priority to eliminating the income and poverty effects of economic deceleration, by providing more long-term finance to SME exporters and by strengthening the strategic development role of Exim Bank in SME capacity building and technology investment.

¹³ The Kapur committee set up by RBI to review the delivery of working capital also recommended that SSI units get at least 20% of the value of their output.

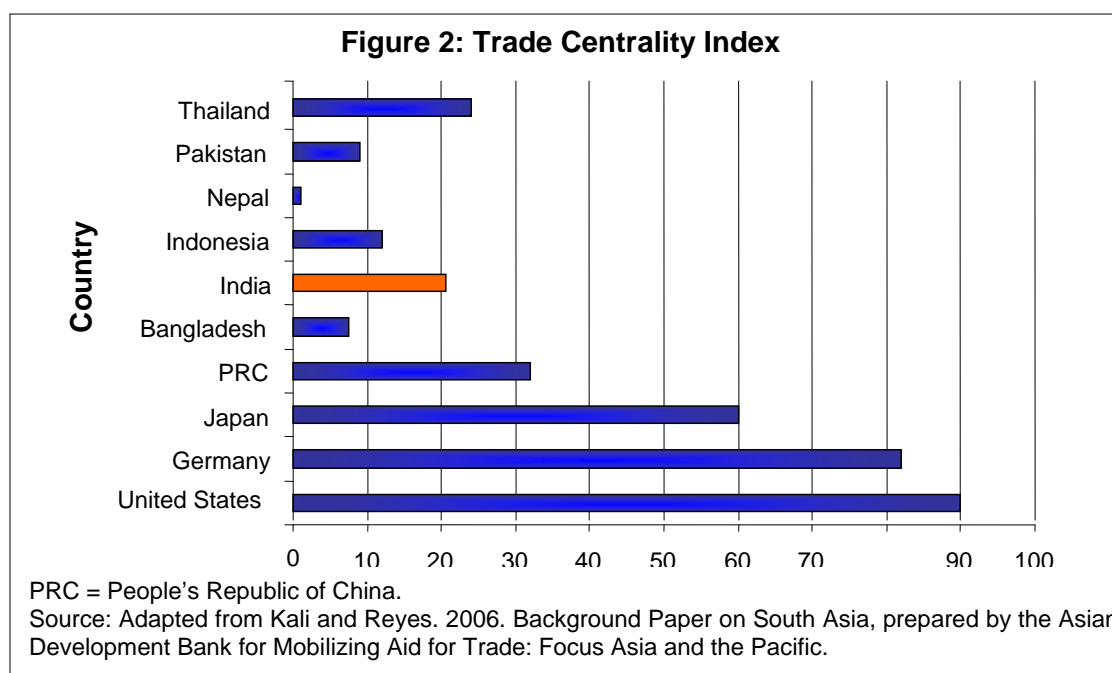
¹⁴ The Ganguly committee also recommended that novel funding schemes for SMEs be introduced especially in backward regions and areas to remove regional imbalances.

¹⁵ Public sector banks have been advised to operate more specialized SSI branches in centers where the financing needs of many SSI borrowers can be served. To moderate the cost of credit to SSI units, banks have been directed to grant lower spreads over the prime lending rate to SSI units with a good borrowing record.

2. Need to Tap Further Trade Potential

22. **Government recognition of the need to act in concert with the private sector.** Recognition of India's tremendous potential to become a global economic player is gaining. The country, with its rich natural resource and mineral base, is now the world's 10th most industrialized in terms of overall industrial production. Banking on the demographic advantage of a large working-age population, India offers the advantage of cheaper labor. It therefore has immense capacity to deliver a wide array of products and services to the global market. The Government is taking action to remove infrastructure and administrative bottlenecks in production and trade. It is (i) simplifying and rationalizing tariff and custom procedures for exports and imports, (ii) reducing restrictions and encouraging competition in the industrial sector, (iii) aligning standards and products with international norms, and (iv) developing infrastructure facilities with the participation of the private sector and SMEs.

23. **Need for better positioning in the international value chain.** The trade centrality index in Figure 2 illustrates an economy's positioning in global value chains and trade networks. A high trade centrality value (on a scale of 0–100) reflects a central position of influence within key global supply and value chains. South Asia is still relatively marginally integrated into the global value chain compared with Germany, Japan, and the United States. India is still a small participant in global production networks, with only a 7% share of parts and components in total manufacturing exports (footnote 2).



3. Need to Prevent Exclusion of Small and Medium Enterprises, Small Farmer Agro-exporters, and Poor and Lagging Regions from Value Chains

24. **Contract manufacturing and production.** This important mechanism, whereby the private sector can establish linkages between SMEs, small-farmer agro-business exports, and markets, requires effective contracting and dispute resolution, along with adequate information channels and contract support, to allow SMEs to enter into collective contracts. SMEs do not

have funds for market research and, on their own, cannot improve design and technical and quality standards to keep up with increasingly complex market demands.

25. Value chain integration leads away from spot purchases by lead firms to the use of specialized procurement agents that can bypass wholesale markets. This shift is made to reduce transaction costs and obtain enough control over quantities, delivery, and quality that cannot be obtained through the spot market. The key to incorporating SMEs into value chains is the development of mechanisms to ensure that the SME products and services meet the size, appearance, safety, quantity, quality, and other requirements of the customer.

4. Importance of Long-Term Trade Finance (Export Finance) for Poor States and Lagging Regions and Trade

26. Improving the trade and investment environment for SMEs in poor states and backward regions is a challenging task. The Government has carefully identified areas for trade reform and is addressing these gradually. More importantly, it has identified the growth potential of emerging markets, especially in Asia, and is making active use of demand stimulated in these regions. Export finance instruments are essential for the effective growth of trade.

27. **Underdeveloped markets for trade finance.** The experience of many developed and developing countries suggests that commercial banks can provide short-term trade finance (especially post-shipment finance) for manufactured goods and services, given the short-term financing need, which normally does not exceed 180 days from shipment. Pre-shipment finance is riskier because the production and prefinancing periods may be longer. The financing of exports and imports of capital goods is normally challenging for commercial banks since the long gestation requires financing tenors that cannot be easily matched with their funding structure. Finally, export markets, particularly the emerging markets, are associated with high credit risk because of uncertainty and information asymmetry over legislation, political stability, and business practice in the destination countries.

28. **Meeting the market gap.** Exim Bank is uniquely mandated to develop export markets in India and leverage banking sector trade finance. Consistent with international good practice, the Government established Exim Bank to spearhead trade finance in areas where the market is undeveloped by commercial banks. While commercial banks' volume of bills discounted is only about 2% of their credit outstanding, their export credit, at about Rs1.1 billion in FY2007, is more than double the FY2003 figure, although its share in overall bank credit has been reduced from about 8% to 6%. Also in FY2003–FY2007, Exim Bank doubled its share of overall export credit, from 4% to 8%. The demand for foreign currency financing of export credit has increased, concurrent with exporters' modernization efforts, such as efforts to integrate into global value chains, raising the proportion of export credit financed with foreign exchange from about 15% in FY2007 to over 40% in FY2005.

5. Policy Dialogue

29. ADB's extensive support for Aid for Trade and the financial sector is in the context of sustained policy dialogue at various levels of Government. Substantive assessment was carried out for the trade sector and export finance market analysis. ADB has been in dialogue with key SME lending institutions such as SIDBI, State Bank of India, and Exim Bank over the last four years. Given the importance of SME exporters in the context of Aid for Trade and its credit strength, ADB has given its priority to support Exim Bank and to keep up the dialogue with State

Bank of India for later transactions.¹⁶ ADB has led efforts to establish the Environmental and Social Management System (ESMS) to ensure compliance with ADB and national environment and social safeguard norms.

6. Value Added and Rationale for ADB Assistance

30. Regional integration through aiding trade for the benefit of poorer regions is a means for inclusive growth.¹⁷ Aid for Trade refers to trade-related capacity building to help countries formulate, negotiate, and implement trade policy and related agreements, as well as trade development, including export promotion and export finance. It also covers support for activities to strengthen trade-related infrastructure and other supply-side capacity (in the productive sector, among others) and trade-related adjustment programs (policy reform and adjustments, social safety nets, etc.).¹⁸

31. Realizing the economic disparities between the two faces of Asia and the Pacific and ADB's long experience in trade-related development, the Aid for Trade initiative is poised to be a core area of ADB assistance in this region. The five core areas where assistance will generally be needed are:

- (i) Trade-related infrastructure. Transport logistics along value chains, energy, and communications are the most obvious.
- (ii) Productive capacity to draw countries into production chains and supply networks, whether regional or global.
- (iii) Adjustment programs. New demand and economic growth require market-oriented reforms, the development of social safety nets, and worker retraining to ease the transition.
- (iv) Trade development, including export promotion and export finance.
- (v) Trade capacity building to help developing member countries negotiate and implement trade agreements.

32. The increasing globalization of value chains presents both risks and opportunities. The lagging regions will be able to exploit their advantage of natural and agro-based resources and labor only if improvements are made in the quality, type, and volume of value chain infrastructure and export finance to match the needs of rapidly developing markets. While Exim Bank is a key financier in Indian export finance, it must increase its role in expanding the reach of export finance to high-potential SMEs in the more disadvantaged regions of India. Consistent with being the market leader, Exim Bank must constantly endeavor to identify products of underdeveloped markets and segments. Its past business growth indicates its limitations to do so on its own; it must therefore find new ways to enlarge the resources available for export finance.

33. The proposed nonsovereign loan to Exim Bank is aligned with the vision and strategic agenda of the Asian Development Bank (ADB) expressed in Strategy 2020. It is also consistent with ADB policy to provide financial assistance without government guarantee to public sector enterprises that have adequate autonomy and managerial skills. As outlined in *Innovation and Efficiency Initiative Pilot Financing Instruments and Modalities* (2005), creditworthy state-owned

¹⁶ ADB is currently working closely with SIDBI for a potential partial credit guarantee operations.

¹⁷ ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank 2008–2020*. Manila.

¹⁸ United Nations Economic Commission for Africa. *Mobilizing Aid for Trade: Focus Africa*. <http://www.uneca.org/aidfortrade/>.

enterprises are potential ADB clients, eligible for direct borrowing independent of sovereign exposure. While commercially oriented, these entities create employment and support economic growth and income generation. Exim Bank fits the eligibility criteria for ADB's nonsovereign financing facility because of its (i) role in opening the market for medium- to long-term export finance to emerging markets and to SMEs, especially in poor and lagging states; (ii) independent and commercially oriented management; (iii) sufficient depth of experience in international export finance; and (iv) strong balance sheet, cost efficiency, and good portfolio quality. Under the proposed nonsovereign loan agreement, Exim Bank will give its assurance that the SME export growth, employment, and SME cluster output targets specified in the design and monitoring framework will be achieved.

34. At the same time, Exim Bank will review and reform its risk management system to fit the Basel II framework to improve its standing in the market. The facility implements an environmental and social safeguard policy that will help maintain and improve the competitiveness and creditworthiness of Exim Bank exporter clients in the context of rising environmental, social safeguard, and other product quality standards in international trade. It will also build more technical capability to help its clients stay competitive in the new, emerging trade environment.

III. THE BORROWER

A. Mandate and Ownership

35. Established under section 3 of the Export-Import Bank of India Act of 1981 (28 of 1981) (Exim Bank Act), Exim Bank is mandated to finance, facilitate, and promote India's international trade. It provides export credit and loans to corporate exporters (including working capital, project finance, equipment finance, credit to buyers and suppliers, and international investment) and refinances commercial banks' trade finance, export guarantees, and advisory services to exporters. Exim Bank also manages about 70 credit lines based on bilateral trade agreements of the Government with developing export markets worldwide.¹⁹

B. Organization Structure and Corporate Governance

36. **Board of directors.** Under section 5(1) of the Exim Bank Act, the board of directors of Exim Bank oversee, direct, and manage its affairs and business. The board, which includes an RBI representative, follows RBI guidelines for the prudential supervision of commercial banks. As part of its off-site surveillance, RBI's department of banking supervision assembles financial information on Exim Bank and monitors its performance including its asset classification, income recognition and provisioning, capital adequacy (now being adjusted to Basel II norms), asset-liability management, and borrower and sector exposure. The Exim Bank Act vests in the board major prudential supervision and rule-making powers to guide the policies and day-to-day business of the bank. The board comprises a chair and managing director appointed by the central Government and up to 15 members who represent the RBI, the Export Credit and Guarantee Corporation, the Industrial Development Bank of India, and up to three scheduled banks, as well as five officials of the central Government and up to four professionals experienced in trade and export finance. As of 31 March 2009, the chair and managing director was supported by 11 other board members including the chairpersons of the State Bank of India, the Bank of Baroda, and the Punjab National Bank (all public sector banks).

¹⁹ Exim Bank manages the Government's Export Development Fund as a separate legal entity and provides macro trade policy advice to the Government.

37. Under the Exim Bank Act, the board has formed committees to set key policies of the bank and oversee its operations. The board management committee, made up of the chair and not more than seven directors, oversees Exim Bank's daily business. The board has delegated oversight authority to (i) the committee of executives, comprising executive directors, chief general managers, and general managers, who approve certain day-to-day business; (ii) the integrated risk management committee, a senior management committee that oversees the credit risk management committee and the asset-liability management committee; and (iii) the audit committee (which comprised five directors as of 31 March 2009).

C. Business Lines and Strategy

38. As mandated, Exim Bank is the Government's financing instrument in support of its trade policy. Despite its policy role, Exim Bank has shown remarkable independence and commercial orientation in its business, as shown by moderate profitability, improving asset quality, and favorable cost-income ratio. Exim Bank over the last 5 years has significantly expanded government-funded lines of credit to India's emerging-market trade partners, which now constitute 13% of its total assets. Over the same period Exim Bank has also expanded its share of refinancing through financial institutions and banks from 14% to 21% of total assets, and its trade finance portfolio has grown in proportion to the bank's overall asset growth, by an average of 23% yearly since FY2004. As a result, the overall loan portfolio of the bank has grown faster (by 26% yearly) than overall assets, indicating a decline in other assets and investments, especially liquidity. Equity investments have remained moderate, at 1% of total assets throughout the period.

39. Since FY2004, the approval values of export contracts supported by Exim Bank have surged by 35% yearly. During the same period, the number of exporters and export countries has doubled, indicating strong diversification of risks. Loan approvals in FY2009 amounted to Rs336 billion, while disbursements grew by 7% to Rs289 billion, reflecting a sharp increase in (i) plant turnkey contracts, which have increased almost 7 times in value over the last 4 years; and (ii) construction contracts, whose value has increased almost 8.5 times over that period. Government-supported programs for technology upgrading more than doubled Exim Bank's business to 10% of overall approvals during the same period, and international investment finance increased its share to 7% of total approvals in FY2009. SME and agribusiness export financing is growing fast, but from a small scale. Export credit has continued to be the dominant business, with 48% of approvals in FY2009.

40. Under the proposed facility, Exim Bank will undertake a major strategic review of its operations including a review of market needs, the identification of risk-sharing arrangements with the Government and the market, and the introduction of corporate environmental and social responsibility into its lending. Some corporate functions may have to be realigned in the coming years to ensure that Exim Bank is well positioned to serve the changing and diversified needs of the trade finance markets.

IV. THE PROPOSED FACILITY

41. The proposed facility consists of (i) a loan of up to \$100,000,000 (denominated in US dollars) and (ii) a TA grant of up to \$1,550,000.

A. The Loan

42. The proposed loan, without government guarantee, will come from ADB's ordinary capital resources. KfW (currently rated AAA) will provide a partial credit guarantee of up to \$50 million of amounts outstanding under the ADB loan. ADB's net exposure to the risk of Exim Bank will therefore be reduced by KfW's risk participation.

43. The loan will be unsecured and will have a tenor of up to 7 years, with an availability period of 12 months and semiannual repayments starting 3 years from the date of first disbursement. It will be subject to conditions precedent to disbursements, including all necessary government and shareholder approvals and consent, and all contractual and financial arrangements satisfactory to ADB. The loan agreement will provide for appropriate (i) representations and warranties; (ii) covenants (affirmative, negative, financial, and information); and (iii) events of default.

44. ADB will enter into a risk participation agreement with KfW, under which KfW will agree to pay ADB 50% of any unpaid amount due from Exim Bank to ADB in the event of default.

45. The proceeds of the loan to Exim Bank will be used for the bank's medium- and long-term lending (except for programs funded out of the government budget) to its SME clients. ADB will monitor lending to SMEs, by region and market, and by cluster location. The loan documentation will include appropriate covenants requiring Exim Bank to target export SMEs incorporated in the states of Assam, Madhya Pradesh, Orissa, and Uttar Pradesh. Exim Bank will ensure that the loan proceeds will be used to finance goods and services from ADB member countries. ADB will require periodic reporting.

46. **Environmental and social safeguards.** The loan is classified as category FI under ADB's *Environment Policy* (2002) and as category C under both ADB's *Involuntary Resettlement Policy* (1995) and *Policy on Indigenous Peoples* (1998). Exim Bank will be required to establish an environmental and social management system following the guidelines in Appendix 3 and setting out detailed screening and assessment procedures, and the system will be reviewed by ADB. As described further below, the TA will support Exim Bank in establishing the environmental and social management system. In addition, Exim Bank will covenant not to use the loan proceeds to finance activities that are on ADB's list of prohibited investment activities.

47. **Anticorruption policy.** Exim Bank was advised of ADB's *Anticorruption Policy* (1998, as amended to date) and policy relating to the *Combating of Money Laundering and the Financing of Terrorism* (2003). Consistent with its commitment to good governance, accountability, and transparency, ADB will require Exim Bank to institute, maintain, and comply with internal procedures and controls following international best practice standards for the purpose of preventing corruption or money laundering activities or the financing of terrorism, and covenant with ADB to refrain from engaging in such activities. The financing documentation between ADB and Exim Bank will further allow ADB to investigate any violation or potential violation of these undertakings.

B. The Technical Assistance Grant

48. The capacity development technical assistance (TA) for the trade finance development facility will support Exim Bank in drafting and implementing a strategy for positioning the bank over the next 5 years (Appendix 4). Critical parameters of the strategy are as follows: (i)

targeting SME export markets, especially in developing countries where India is well positioned; (ii) identifying the financing needs and risks of global value chains originating from India; (iii) assessing the suitability of Exim Bank products; (iv) developing approaches to leveraging resources through structured financing involving the structuring of risk layers to be borne by the Government (first loss, junior debt), Exim Bank (mezzanine debt), and private finance (senior debt), as well as the phasing in of Basel II principles; and (v) introducing an environmental and social responsibility policy. The TA will therefore help strengthen Exim Bank's role as the lead development agency for export finance, thereby facilitating private sector entry into the export markets.

49. The cost of the TA is estimated at \$1,550,000 equivalent (in Indian rupees). ADB will provide a grant of (up to) \$1,550,000 from its Technical Assistance Special Fund (TASF—other sources). Exim Bank will contribute (in kind) an amount of \$1,000,000 equivalent for staff, office accommodation, and logistical support. The TA will be implemented over 36 months, from the time the TA takes effect. It will be overseen by a dedicated senior team appointed by and reporting to the Exim Bank chair and managing director and the board. A firm will be selected under the quality-based method in accordance with ADB's *Guidelines on the Use of Consultants* (2007, as amended from time to time). Disbursements under the TA will conform to ADB's *Technical Assistance Disbursement Handbook*.²⁰

V. BENEFITS, IMPACT, AND RISKS

A. Benefits, Impact, and Asian Development Bank Value Addition

50. **High development impact.** The proposed facility will help India meet its trade development objectives, for sustained economic growth. With the facility, 50,000 or more jobs will be created in SME export clusters in lagging regions, with at least \$1 billion in incremental export production in an increasing variety of products. International experience suggests a strong association between a country's trade openness and the individual incomes of its citizens, pointing to the substantial trickle-down effects of trade through the producer value chain to small manufacturing businesses and agricultural producers. This is consistent with the findings of the United Nations Conference on Trade and Development (footnote 1) and the G8, G24, and WTO, indicating that Aid for Trade is an effective tool for poverty reduction. The benefits from trade are most visible in a context where regulatory reform and process simplification go hand in hand with the building of trade infrastructure and capacity. The role of government support for export finance is particularly important for SME trade with emerging markets, which is exposed to higher legal, regulatory, and political risks (Appendix 5), especially in the difficult global market environment at present. The link of export finance and capacity building support will increase SME market access and economic opportunities especially in Asia.

51. **Public good provision for regional integration of India's SME exporters.** The expansion of export credit and finance will provide modernizing exporters with a reliable source of financing for medium- and long-term investments in skills, plant, and technology. It will also facilitate the extension of existing value chains to SMEs and producers of export components and inputs, as well as expansion into new markets. Indian producers still have limited contribution to global value chains, but there is vast potential for strengthening their position and value added. The benefits of strengthening forward integration value chains through export finance are especially large. Southeast Asia and East Asia provide some of the best prospects

²⁰ ADB. 2008. *Technical Assistance Disbursement Handbook*. Manila.

for forward integration for India's producers, since these constitute the middle segment that links Southeast Asia to the markets of the European Union, Japan, and the United States. Hence, Exim Bank's expansion of export credit to SME suppliers that deliver to Southeast Asian networks will have immediate benefits for India's export competitiveness. SME exporters will be able to adjust to a shift to trade that is more Asia-driven than in the past.

52. Mobilization of long-term export finance for trade diversifications decreases economic vulnerability. The facility will improve Exim Bank's ability to lend long-term foreign currency funds to Indian exporters that match their cash flow. It supports the Government's strategy of diversifying trade into new emerging countries, with a particular emphasis on South Asia and East Asia, and widening the products and industry sectors covered. It is in line with ADB's Strategy 2020 and the country strategy for India to promote trade and financial sector development. The loan will be without a government guarantee and will therefore reduce the burden of contingent liabilities and budget constraints associated with government-funded or guaranteed borrowing.

53. ADB's involvement improves Exim Bank corporate governance, financial risk management, strengthens environment and social safeguards, and leads Exim Bank's strategic reorientation towards developing new market segments. The facility will be a major contribution to Exim Bank's institutional development. It will enable the bank to position itself as a modern trade financier leveraging other commercial resources into new markets. The absence of long-term export finance leads to suboptimal allocation of private sector investment to SME export capacity expansion and technology improvement. The facility applies prudent Basel II risk management to Exim Bank market opening, and implements an environmental and social safeguard policy that will help to maintain and improve the competitiveness and creditworthiness of Exim Bank exporter clients in the context of rising environmental, social safeguard, and other product quality standards in international trade.

VI. ASSURANCES

54. No-objection letter. The Government has confirmed that it has no objection to the proposed financing for Exim Bank.

55. Loan documentation. ADB will enter into suitable documentation, in form and substance satisfactory to ADB, after the proposed financing is approved by ADB's Board of Directors.

VII. RECOMMENDATION

56. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

- (i) the loan of up to \$100,000,000 (denominated in US dollars), supported by a partial credit guarantee from KfW Bankengruppe, to the Export-Import Bank of India from ADB's ordinary capital resources, with a tenor of up to 7 years, including a grace period of up to 3 years; and
- (ii) the provision of technical assistance not exceeding the equivalent of \$1,550,000 to the Export-Import Bank of India,

in each case, for the Small and Medium Enterprise Trade Finance Development Facility, and on such other terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board.

Haruhiko Kuroda
President

9 September 2009

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and Indicators^a	Data Sources and Reporting Mechanisms	Assumptions and Risks
<p>Impact Increased SME access to markets and economic opportunities</p>	<p>Decrease in unit costs and in lead times for key South Asia SME export products</p> <p>Increased diversification of SME exports, especially into labor-intensive products, and increasingly into Asian markets</p> <p>Increased share of exports by SMEs, with an SME export growth rate above total export growth</p>	<p>Trade and logistics statistics from WTO, UNCTAD, World Bank, World Economic Forum, OECD, RBI</p>	<p>Assumption Government supports for private sector-led growth</p> <p>Risks International trade policies interfere with openness</p> <p>Investment in social (health, education) and economic (trade) infrastructure is inadequate</p>
<p>Outcome Expanded reach of long-term trade finance (export finance) to high-potential SMEs in more-disadvantaged, poor regions of India, and through Exim Bank as a market catalyst for other financiers</p>	<p>Increased trade-induced employment in lagging states and poorer regions for at least 50,000 persons, as related to Exim Bank investments</p> <p>Measured cost of establishing new business, and increase in business establishments in specific lagging states (increase in entry rate)</p> <p>Increased SME export activities and by market, as related to Exim Bank activities in lagging states (\$1 billion incremental trade over 10 years)</p> <p>Increase from 8% to 18% in share of total trade credit for SMEs in total bank trade credit</p> <p>4% annual increase in share of SME export credit in total credit to lagging states and poor regions, from mid-2009</p> <p>Successful commercial debt finance or bond issue in international capital market</p>	<p>Ministry MSME, RBI, Exim Bank reporting</p>	<p>Assumptions Political will and stability is maintained</p> <p>International market access conditions improve</p> <p>Risks Government ministries' technical agencies do not cooperate</p> <p>ADB credit enhancement may not overcome international capital market access barrier</p>

Design Summary	Performance Targets and Indicators^a	Data Sources and Reporting Mechanisms	Assumptions and Risks
<p>Outputs</p> <ol style="list-style-type: none"> 1. Expansion of longer-maturity export credit and finance for investments in SME skills, plant, and technology 2. Promotion of lagging and poorer regions' SME "bankability" with the establishment of value chain and production clusters for diversified SME exports 3. Increase in SME productive and managerial capacity (with special attention to women-led SMEs) and related new jobs created for new markets 4. Implementation plan to build up Exim Bank's institutional capacity for review of its business model, strategy overhaul for repositioning as SME export financier in the globalizing trade environment, and introduction of Basel II risk management, environmental and new social responsibility procedures and systems 	<p>Increase from 2% to 10% in Exim Bank's share of long-term SME trade credit portfolio as part of overall lending portfolio</p> <p>Measured cost and time along value chain steps to identify impact in terms of lowered business cost and higher benefit from critical Exim Bank SME investments that remove key trade competitiveness constraints, especially in lagging regions (cost and time to import and export)</p> <p>Increased trade-induced employment in lagging states and poorer regions for at least 50,000 persons, as related to Exim Bank investments</p> <p>Comparison between achieved capacity and original capacity in terms of higher volumes of SME export sale (target: \$1 billion additional trade), and number of employees in businesses of SME borrowers</p> <p>International risk management and environment and social safeguard standards met and exceeded by Exim Bank</p>	<p>Field investigation</p> <p>International comparators and market analysis, and (in)efficiency measures</p> <p>Exim Bank reporting</p>	<p>Coordination arrangements between public and private sectors for investment and business environment are adequate in lagging states</p> <p>International and national technical expertise can be accessed</p> <p>Finance and technical expertise can be absorbed by SMEs</p> <p>Exim Bank is committed to strengthened corporate governance, credit risk management, and risk base loan pricing, under Basel II</p> <p>Lead corporate firms drive the establishment of SME value chain clusters with Exim Bank in a catalyzing role</p> <p>Risks</p> <p>Surge in demand for trade finance could translate into asset quality problems at Exim Bank</p> <p>Exim Bank could remain "too distant" to its SME clients</p> <p>SMEs' inherent vulnerability to economic downturns could adversely affect their financial condition and performance</p>

Activities with Milestones	Inputs
<ol style="list-style-type: none"> 1. Access to export finance: Disbursement to SMEs and their location, tracking, and reporting; increase in export finance lending portfolio (starting no later than Q1 2010) 2. Improvement of SME bankability in lagging regions: Promotion of establishment and development of SME value chain clusters with at least three value chain clusters in lagging regions, to be developed in sectors with high export and employment creation potential (from Q2 2010) 3. Exim Bank lending to bankable SMEs and SME value chain clusters in lagging regions established by lead firms (starting no later than Q2 2010) 4. Institutional capacity building of Exim Bank <ol style="list-style-type: none"> 4.1 Scoping workshops with South Asia and eminent international experts (Q2 2010) 4.2 Work program; consultants' interim and midterm reports 4.3 Draft final report (Q2 2012) 4.4 Knowledge management activities, as appropriate, to disseminate results and outputs (continuing) 4.5 Final report (Q3 2012) 	<p>Loan proceeds of up to \$100,000,000 with a tenor of up to 7 years for medium- and long-term loans to SME clients of Exim Bank</p> <p>Technical assistance grant of \$1,550,000 for 33 international person-months, 70 national person-months, reports, presentations, website, training</p>

Exim Bank = Export-Import Bank of India; MSME = micro, small, and medium enterprise; OECD = Organisation for Economic Co-operation and Development; Q1 = first quarter; Q2 = second quarter; Q3 = third quarter, RBI = Reserve Bank of India; SME = small and medium enterprise; UNCTAD = United Nations Conference on Trade and Development; WTO = World Trade Organization.

^a For details on assured indicators, see Appendix 6.

SMALL AND MEDIUM ENTERPRISE TRADE SECTOR

A. Global Perspective¹

1. **The global economic growth slowdown.** Global economic growth in 2009 is projected to slow down to close to 0%, from a recent average of 3.5%. Per capita growth in 2009 will be negative (Tables A2.1 and A2.2). It is also estimated that a 1% decline in world growth leads to at least a 3% decline in trade, for a multiplier effect of 3 from world growth to trade.

Table A2.1: World Output Growth, 1991–2008
(% annual change in constant 2000 prices)

Economy	1991–2000 ^a	2001	2002	2003	2004	2005	2006	2007 ^b	2008 ^c	2009 ^c
World	2.9	1.5	1.8	2.6	4.1	3.4	4.0	3.8	3.4	(1.4)
Developed Countries	2.5	1.1	1.2	1.8	3.1	2.4	3.0	2.5	1.6	(3.8)
Eastern Europe,										
Central Asia	(4.2)	5.9	5.2	7.1	7.7	6.4	7.5	8.4	7.4	(5.0)
Russian Federation	(4.7)	5.1	4.7	7.3	7.2	6.4	6.7	8.1	7.5	(6.5)
Developing Countries	5.0	2.6	3.8	5.1	7.1	6.5	6.9	7.3	6.4	1.5
Africa	2.7	3.7	3.4	4.9	5.3	5.3	5.9	5.8	6.0	1.8
Latin America,										
Caribbean	3.2	0.3	(0.5)	2.1	6.2	4.8	5.7	5.7	4.6	(2.6)
Mexico	3.1	(0.0)	0.8	1.4	4.2	3.0	4.8	3.2	2.8	—
Brazil	2.9	1.3	2.7	1.1	5.7	2.9	3.7	5.4	4.8	1.8
Asia	6.5	3.5	5.9	6.5	7.8	7.4	7.6	8.1	7.2	5.5
East Asia	8.5	5.0	7.3	6.9	8.2	7.8	8.4	9.1	8.1	—
PRC	12.4	8.3	9.1	10.0	10.1	10.2	10.7	11.4	10.0	7.5
South Asia	5.3	4.4	4.7	7.0	7.7	8.0	7.9	8.5	7.0	4.8
India	6.0	5.0	4.0	7.1	8.5	9.2	9.2	9.7	7.6	5.4
Southeast Asia	5.1	2.1	4.8	5.4	6.6	5.7	6.0	6.4	5.4	0.7
West Asia	3.9	(0.9)	3.5	5.4	7.8	6.9	5.5	5.1	5.7	—

() = negative, — = not available, PRC = People's Republic of China.

^a Average.

^b Preliminary estimates.

^c Forecast.

Source: United Nations Conference on Trade and Development. 2008. *Trade and Development Report*. Geneva; International Monetary Fund. 2009.

2. From this, it is expected that, for instance, world trade volume in goods would see a decline into negative territory from an average 2001–2006 annual increase of 6%. In fact, a double-digit drop in South Asia exports is projected in 2009.

3. **Temporary halt in per capita income increase.** Per capita gross domestic product (GDP) increased by 16% in 1981–2007 in Africa and West Asia, and by 23% in Latin America. Since 2003, Africa, Latin America, and West Asia have achieved high and stable growth after more than 2 decades of stagnation. GDP per capita in East and South Asia accelerated, reaching overall growth of more than 300% in 1981–2007 and doubling in only 14 years. The global slowdown in 2009 is projected to lower annual growth by 2.5%–4.0% in East and South Asia.

¹ This section is based on United Nations Conference on Trade and Development. 2007. *Trade and Development Report*. Geneva.

Table A2.2: Per Capita GDP Growth, 1981–2007
(%)

Economy	Average Annual Growth			Overall Growth	
	1981–1989	1990–2002	2003–2007	1981–2007	2009
World	1.4	1.2	2.3	41.4	—
Developed economies	2.5	1.8	2.0	67.5	—
Economies in transition	1.9	(4.0)	7.3	(25.8)	—
Developing economies	1.7	3.0	5.0	112.5	—
Of which:					
Africa	(0.5)	0.3	3.0	16.4	—
America	(0.3)	1.1	3.5	22.7	—
West Asia	(1.7)	1.1	4.1	16.0	—
East and South Asia	5.1	5.3	6.3	317.5	3.0

() = negative, — = not available, GDP = gross domestic product.

Sources: United Nations Conference on Trade and Development. 2007. *Trade and Development Report*. Geneva; Asian Development Bank. 2009. *Asian Development Outlook 2009*. Manila.

4. **Impact on employment and poverty.** In this unfavorable economic climate, developing economies will temporarily forgo strong growth in employment, which characterized the 2003–2007 period. With stagnating per capita GDP growth comes employment stagnation and a move toward increased informal employment. Poverty rates are likely to nudge upward in 2009 in developing Asia, including India.

5. **Growth of world trade.** Since 2001, world trade volume has been positively influenced by continued strong demand from developed economies and a surging demand from developing countries. After years of decline, demand surged in Southeast Europe and Central Asia as well as Africa. Asia, especially East, South, and West Asia, witnessed a very strong surge in import demand and exports at more than double the average growth in world trade volume, driven by the performance of the People's Republic of China (PRC) and India (Table A2.3). This picture, of course, has changed in 2009, with exports and imports combined in double-digit decline worldwide (OECD estimates, July 2009). As the gearing ratio of world income growth decrease to world trade volume decrease is at least 1 to 3, India's openness to the world economy will decline in 2009 by an estimated 2%–3%. Simulation indicates that a 1% increase (or decline) in the share of trade in GDP is expected to decrease (or increase) the country poverty rate by 0.6%. India has to invest now in structural adjustments to global, regional, and domestic shifts in market preferences, with growth and trade becoming more Asia-driven in the future.

Table A2.3: Annual Average Growth of Goods Trade Volume, 2001–2006
(%)

Economy	Exports	Imports	Exports	Imports	Exports and Imports
World	5.7	6.0	2.1	2.2	(16.0)
Developed Economies	4.7	4.7	0.0	(1.1)	(15.6)
Eastern Europe and Central Asia	7.3	16.2	4.5	15.5	—
Developing Economies	8.7	9.0	4.8	6.3	—
Africa	3.5	8.3	3.6	10.5	—
Latin America, Caribbean	4.0	4.7	4.1	3.6	(23.8)
East Asia	15.7	11.2	5.3	4.4	} (16.4)
People's Republic of China	24.8	19.3	6.2	10.6	
South Asia	9.3	11.3	3.9	21.3	
India	13.8	13.3	—	—	
Southeast Asia	7.2	6.2	—	—	
West Asia	4.3	12.5	3.9	8.5	

() = negative. — = not available

Sources: United Nations Conference on Trade and Development (UNCTAD). 2007. *Trade and Development Report*. Geneva; UNCTAD. 2009. *World Economic Situation and Prospects*. Geneva; and Organization Economic Co-Operation and Development (OECD). 2009. *OECD Economic Outlook*. Paris.

6. **Asia's share in global exports.** The developing countries' share in export value increased from 32% in 2000 to 40% in 2007. Excluding Japan, Asia's share in global exports increased from 15% to 24%, while Africa's share increased only slightly, from 2.3% to 2.8%; the share of Latin America and the Caribbean remained just below 6%; and that of Southeast Europe and Central Asia increased from 2.6% to 4.1%.

Table A2.4: Selected Asian Countries' Growth and Share in World Exports
(%)

Economy	Average Growth Rate				Share in World Exports				
	1995–2001	2004	2005	2006 ^a	1995–2001	2004	2005	2006 ^a	2007
PRC	12.4	35.4	28.5	25.8	4.3	6.6	7.4	7.8	8.0
Hong Kong, China	3.6	15.6	11.6	8.6	3.1	2.9	2.8	2.6	2.7
India	8.5	25.7	30.0	40.4	0.8	1.2	1.5	1.8	1.9
Indonesia	5.7	11.7	18.2	17.4	0.9	0.8	0.8	0.9	0.8
Korea, Republic of	7.4	30.9	11.8	13.7	2.5	2.8	2.7	2.7	—
Malaysia	6.6	26.5	12.1	15.1	1.4	1.4	1.4	1.4	1.3
Singapore	4.1	24.5	15.6	34.5	2.0	2.0	2.2	2.3	2.2
Thailand	5.9	20.0	14.6	20.0	1.1	1.1	1.1	1.1	1.1

— = no data available, PRC = People's Republic of China.

^a Figures for 2006 are from January to August.

Source: International Monetary Fund. 2007. *International Financial Statistics*. Washington, DC.

7. **Manufacturing value added concentrated in developed economies.** Manufacturing value added in East Asia increased in the early 1990s but has remained stable since. The European Union has retained its position in manufactured trade and intraregional trade (Table A2.5).

Table A2.5: Manufacturing Value Added and Trade in Manufactures, 1991–2005
(%)

Region	1991	1995	2000	2005
Share in World Manufacturing Value Added				
European Union-15 states	29.8	27.6	23.6	27.6
NAFTA	24.9	24.9	30.5	25.4
East Asia	25.3	29.5	29.4	29.7
Total	80.0	82.1	83.5	82.7
Share of Region's Manufactured Trade in World Manufactured Trade				
European Union-15 states	—	39.9	36.0	36.4
NAFTA	—	19.1	24.0	18.8
East Asia	—	20.5	20.4	22.2
Total	—	79.5	80.4	77.4
Share of Intraregional Trade in Manufactures in World Trade in Manufactures				
European Union-15 states	—	24.9	21.2	21.2
NAFTA	—	7.9	11.1	7.8
East Asia	—	8.0	8.2	10.3
Total	—	40.7	40.5	39.3

— = no data available, NAFTA = North American Free Trade Agreement.

Source: United Nations Conference on Trade and Development. 2007. *Trade and Development Report*. Geneva.

8. **Growth of intraregional trade.** The emergence of intraregional trade in Asia over the past 5 decades as the third hub of world trade next to Europe and North America has followed a distinctive pattern. Following Japan's export success in the 1950s and 1960s, the newly industrializing economies began to enter export markets as Japan's industrial structure shifted away from labor-intensive products to more sophisticated ones. As profitability fell at home, producers from Japan and the newly industrializing economies began to move their production

chains into Southeast Asia in the 1980s. At the same time, rapid advances in production, transport, and communications technology created opportunities for investors to redesign production processes in the 1990s and 2000s, in ways that encouraged the splitting up of fabrication and assembly processes. In developing countries, members of the ASEAN have the highest share of intraregional trade, with a weighted average of 75%. East and Southeast Asian countries accounted for almost 50% of total ASEAN trade in 2005, compared with only 30% in 1990. The ongoing process of global production sharing—in which developing Asian economies are increasingly integrated into intraregional production networks (supply chains)—underlies rapid growth in manufactured products such as machinery and transport equipment.

9. The trade proportion of parts and components in developing Asia has increased continuously since the early 1990s.² In terms of exports, it increased from 16% of total manufacturing exports in 1992 to 25% in 2006. In contrast, exports of parts and components from India are limited. The share of India's parts and components in total manufacturing exports was only 7% in 2006, from 3% in 1992.

B. India's Trade

1. Economic Reforms

10. For much of the first 4 decades since its independence, India followed an autarchic development model encouraging import substitution and protection of domestic products and services, and keeping a tightly controlled capital account. After a balance-of-payments crisis in 1991, the Government recognized the need for reform and the fact that high protection was associated with low rates of economic growth and low income of its citizens.

11. **First generation of reforms.** These were initiated in the early 1990s and were characterized by the facilitation of foreign direct investment (FDI); a policy fostering the privatization of nonstrategic state-owned enterprises; and the development of capital market infrastructure for the corporate bond and equity markets, pension reforms, increased licensing of private banks, improved prudential regulation and supervision of banking through the Reserve Bank of India (RBI), and improved supervision of capital markets through the Securities and Exchange Board of India. Concurrent with the structural reforms, India moved from an exclusively government-managed and highly regulated financial sector to a more market-oriented regime by introducing indirect instruments of monetary policy, and admitting private banks to stimulate competition. Important milestones include

- (i) massive reduction of statutory liquidity from 37% in 1991 to 25% in 1997 and cash reserve requirements from 15% to 5% in 2005;
- (ii) effective deregulation of interest rates by 1997, except for the smallest loans;
- (iii) entry of private and foreign banks, with the 19 new private and 31 foreign banks and the private sector holding a 26% share of banking assets;
- (iv) establishment of a securities market regulator in 1992 and the national stock exchange in 1994 (now the leading stock exchange in the country);
- (v) introduction of infrastructure and secondary markets for corporate bonds and development of a maturity yield curve through the issue of government bonds;
- (vi) development of market intermediaries such as private mutual funds (1993) and private insurance companies (2000); and

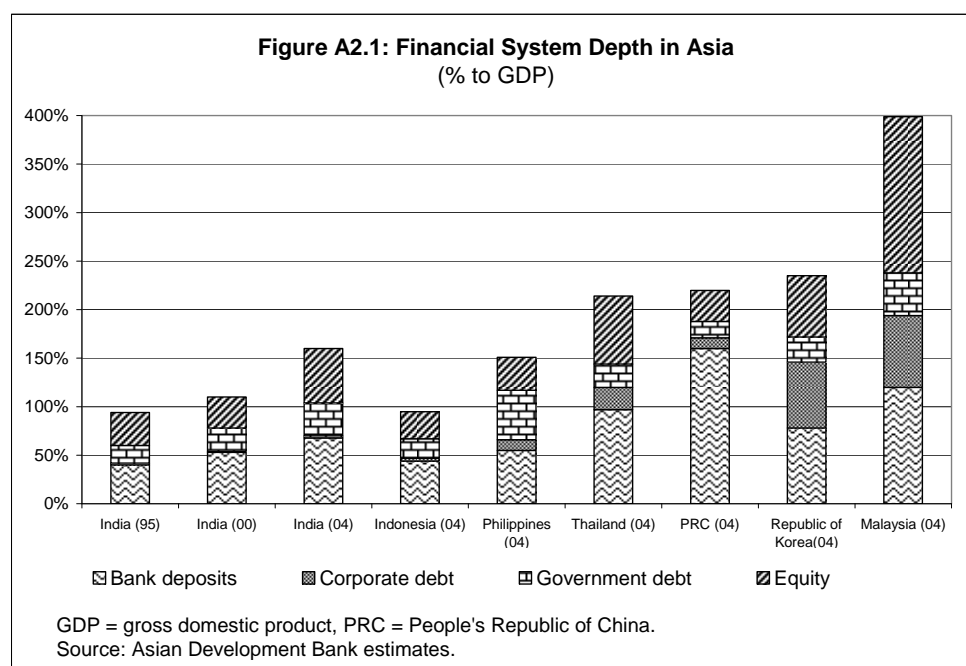
² Jongwanich, J., W, James, P. Minor, and A. Greenbaum. 2009. Trade Structure and the Transmission of Economic Distress in the High-Income OECD Countries to Developing Asia. *Asian Development Review*. 26 (1). Manila: Asian Development Bank.

- (vii) adoption of a market-determined exchange rate in 1993, current account convertibility in 1994, and gradual capital account liberalization.

12. **Alignment of domestic and international standards.** Subsequent to the Asian financial crisis, the Government established a standing committee on international financial standards and codes in December 1999 to benchmark its practice following recommendations made by the financial stability forum on (i) accounting and auditing, (ii) banking supervision, (iii) bankruptcy, (iv) corporate governance, (v) data dissemination, (vi) fiscal transparency, (vii) insurance regulation, (viii) transparency of monetary and financial policies, (ix) payments and settlements system, and (x) securities market regulation.

13. **Money laundering and financing of terrorism.** Implementing a 1998 United Nations resolution, Parliament promulgated the Prevention of Money Laundering Act in July 2002. RBI constituted the Committee on Bank Frauds in 1999, putting in place procedures, systems, and controls to help combat money laundering. RBI issued a circular to banks prescribing “know your customer” guidelines and directing them to monitor suspicious cash transactions. The directives require banks to adopt appropriate policies and procedures for (i) customer identification, (ii) monitoring of suspicious transactions, and (iii) screening and reporting of transactions of terrorist entities or of entities suspected of fronting for terrorist activities.

14. **Improved legal framework for banking.** Legal reforms include the passage of security laws and the Negotiable Instruments Act. RBI has proposed comprehensive amendments to the RBI Act of 1934 and the Banking Regulation Act of 1949. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (2002) regulates the securitization and restructuring of financial assets and the enforcement of debt security, improving creditor rights. The nonperforming loans of commercial banks have decreased substantially.



15. Notwithstanding this progress, India's financial sector is still behind the Asian emerging markets and has only recently improved its depth in the economy. Total financial system assets are still low; despite a high savings rate, most assets are channeled into government debt

through the government-dominated banking system or into low-quality priority sector loans. Currently, only about 40% of credit is available to the private sector, while the bulk goes to priority sectors and state-owned entities. Most importantly, the corporate bond market is underdeveloped, constituting only 2% of GDP in FY2004; a more significant proportion is being issued by government paper or through private placements.

2. Trade Growth

16. **High-growth trajectory.** As a result of the structural reforms initiated in the early 1990s, a favorable world economy, and increasing globalization of businesses, India has benefited significantly from high economic growth, averaging 7.8% since FY2002 (Table A2.6). This is substantially above the average annual 4% achieved over the preceding 5 decades. Participating in the increasing globalization of the world economy and concurrent with impressive domestic growth, foreign merchandise trade volume grew substantially at an annual average of 22% for exports, tripling over the 5-year period since FY2002, and 28% for imports, a more-than-fourfold increase. India's exports of services, especially for information technology, biotechnology, call centers, and other administrative outsourcing services, are an engine of growth, expanding by an annual average of 34%, while imports of services from abroad expanded by an annual average of 22%. The ratio of merchandise exports to GDP increased from 5.8% in FY1991 to 13.9% in FY2007, while the ratio of imports to GDP increased from 8.8% to 21.1%. The global slowdown has brought this trend to a temporary halt.

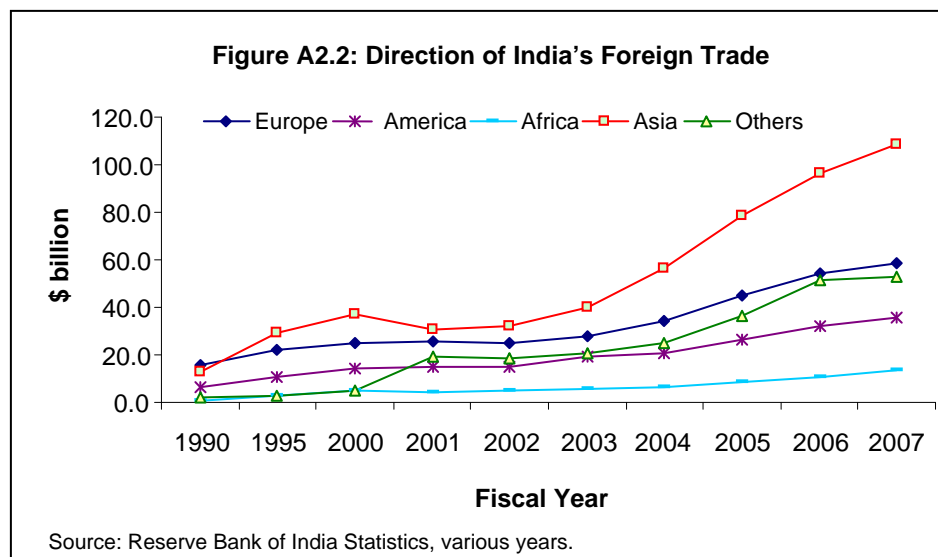
Table A2.6: India's Foreign Trade, 1991–2008
(% of GDP)

Item	FY1991	FY2001	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008
Trade: Exports	5.8	9.9	10.6	11.0	12.2	13.1	13.9	15.4
Imports	8.8	12.6	12.7	13.3	17.1	19.5	21.1	23.7
Invisibles: Receipts	2.4	7.0	8.2	8.9	10.0	11.5	13.0	13.8
Payments	2.4	4.9	4.9	4.3	5.5	6.2	7.0	6.9
Current Account: Receipts	8.0	16.9	18.7	19.8	22.1	24.4	26.9	29.1
Payments	11.2	17.5	17.6	17.6	22.6	25.7	28.0	30.7
Capital Account: Foreign investment	—	1.5	1.2	2.6	2.2	2.5	2.9	3.4
Capital inflows	7.2	11.8	9.1	12.6	14.1	17.6	24.8	40.1
Capital outflows	5.0	9.8	7.0	9.8	10.1	14.7	19.9	30.1
Import Cover of Reserves (months)	2.5	8.9	14.2	16.9	14.3	11.6	12.4	13.9

— = no data available, FY = fiscal year, GDP = gross domestic product.

Source: Ministry of Finance, Government of India. 2008. *Union Budget and Economic Survey 2008*. Delhi.

17. **Diversification of trade into new growth markets.** Although the United States remains India's largest trade partner, its importance is declining, while that of Asian, and even African countries, is picking up. Since FY2001, the United States' share of India's trade declined from 13% to 9.7%, while the PRC's increased from 2.5% to 7.7%, and that of the United Arab Emirates increased from 3.4% to 6.9%. While trade with the United States and Europe will remain significant, it will grow at a slower pace compared with trade with the new markets. India recently identified opportunities for trade with South Asia, Southeast Asia, and Africa. Figure A2.2 illustrates India's recent impressive trade growth, especially in Asia. Growing intraregional trade will help India rebalance growth to Asia.



18. **Balance of payments, trade deficit, and net capital inflows.** India's foreign trade continued with its strong momentum in FY2007, with exports growing annually by 26% and imports by 18%. The trade deficit rose to \$65 billion from \$52 billion. India's foreign trade grew moderately in FY2007 for exports of primary products, while manufactured products declined, as a result of a decline in exports of gems and jewelry, textiles, chemicals, ores, and minerals, while exports of agricultural products (tea, spices, sugar, and molasses), engineering goods, and petroleum products maintained their growth momentum. Engineering goods and petroleum products contributed 62% to the total export growth in FY2007. India's merchandise imports dropped to 28% during the same period, compared with a 34% growth in FY2006. Oil imports grew by 30% in FY2007 (versus 47% in FY2006), largely reflecting surging oil prices, and imports of ores and metal scrap (126%), machinery (42%), gold and silver (32%), and electronic goods (25%) grew significantly, reflecting the construction boom associated with India's growth as well as increases in the prices of primary products. The significant export growth attests to India's growing competitiveness and favorable world demand, while the growth in imports may be largely attributed to the buoyant Indian manufacturing sector and increasing demand and prices.

19. Services, transfers, and income transfers remained buoyant in FY2007, led by robust export growth of software and other services and supported private remittances. In FY2007, India's net inflow of invisibles amounted to \$55.3 billion (\$42.7 billion in FY2006). Service exports increased by nearly 60% yearly on average from FY2001 and stood at \$81.3 billion in FY2007, supported by software and business services. The favorable investment climate, especially the surge in outsourcing of information technology, software, and business services, led to an increase in the proportion of service current account inflows from 23% to 30% over only 3 years. The robust growth of the trade in invisibles kept the current account deficit to \$9.6 billion in FY2007.

20. **Surge of capital inflows and outflows.** On the capital account, FDI in India tripled to \$19 billion, and Indian investments abroad almost quintupled to \$11 billion in FY2006 and FY2007, leading to a net FDI of \$8.4 billion in FY2007. External commercial borrowings tripled to \$16 billion during the same period, and the recent dramatic surge in FY2007 led to increasing

RBI concerns about inflationary pressures associated with external commercial borrowings channeled into the Indian economy, and its call for corrective action in April 2007 (Table A2.9).

Table A2.7: India—Growth and Composition of Service Exports
(%)

Item	FY1991	FY2001	FY2004	FY2005	FY2006	FY2007	FY2008
Software and others	—	39.0	47.6	40.9	38.4	38.5	67.0
Travel	32.0	21.5	18.7	15.4	12.8	11.6	11.4
Transportation	21.6	12.6	11.9	10.8	10.2	9.9	10.0
Insurance	2.4	1.7	1.6	2.0	1.7	1.5	1.6
Total (\$ billion)	4.6	16.3	26.8	43.2	61.4	81.3	90.0
Average annual growth FY1991–2001–2007		25.0				57.0	

— = no data available, FY = fiscal year.

Source: Reserve Bank of India. 2008. *Annual Report 2008*. New Delhi.

Table A2.8: India Balance of Payments (Current Account)

Item	Amount (\$ billion)			% change			Structure in % of current account inflows		
	FY2006	FY2007	FY2008	FY2006	FY2007	FY2008	FY2006	FY2007	FY2008
Exports	105.2	127.1	166.1	23	21	31	61	61	59
Imports	157.0	192.0	257.7	32	22	34	—	—	—
Trade balance	(51.8)	(64.9)	(91.6)	—	—	41	—	—	—
Invisibles, net	42.7	55.3	74.6	37	30	35	25	26	26
Nonfactor services	23.9	32.7	37.4	55	37	14	14	16	13
Software services	22.3	28.8	37.2	32	29	29	13	14	13
Income	(5.5)	(4.8)	(4.9)	10	(13)	3	—	—	—
Private transfers	24.1	27.2	41.7	17	13	53	14	13	15
Official transfers	0.2	0.2	0.2	(33)	—	—	—	—	—
Current account balance	(9.2)	(9.6)	(17.0)	—	—	77	—	—	—
Inflows current account	172.2	209.8	282.6	25	22	35	100	100	100
Outflows current account	162.5	196.8	262.6	—	—	33	—	—	—

() = negative, — = no data available, FY = fiscal year.

Source: Reserve Bank of India. 2008. *Annual Report 2008*. New Delhi.

Table A2.9: India Balance of Payments (Capital Account)

Item	Amount (\$ billion)			% change			Structure in % of capital account inflows		
	FY2006	FY2007	FY2008	FY2006	FY2007	FY2008	FY2006	FY2007	FY2008
Foreign investment, net	17.3	15.5	45.0	33	(10)	190	—	—	—
Direct investment	4.8	8.4	15.0	30	75	83	18	15	35
- In India	7.7	19.4	34.0	28	152	76	29	35	12
- International	(2.9)	(11.0)	(19.0)	26	279	71	11	20	27
Portfolio investment	12.5	7.1	30.0	34	(43)	317	46	13	(15)
- In India	12.5	7.0	29.0	34	(44)	320	—	—	23
External assistance, net	1.7	1.8	2.0	(11)	6	17	6	3	2
Commercial borrowings, net	2.7	16.1	23.0	(48)	496	40	10	29	18
Short-term credit, net	1.7	3.3	17.0	(55)	94	421	6	6	14
Banking capital	1.4	2.1	12.0	(64)	50	462	5	4	9
Rupee debt service	(0.6)	(0.2)	(0.1)	50	(67)	(50)	—	—	—
Other capital, net	(0.7)	6.4	10.0	(200)	(1,014)	48	(3)	11	7
Total capital account	23.5	45.0	108.0	(16)	91	140	—	—	85
Errors and omissions	0.8	1.3	1.0	—	—	—	—	—	1
Overall balance	15.1	36.7	92.0	(42)	143	151	—	—	73
Inflow capital account	27.0	56.2	127.0	(12)	108	126	100	100	100
Outflow capital account	(3.5)	(11.2)	(19.0)	—	—	—	—	—	—

() = negative, — = no data available, FY = fiscal year.

Source: Reserve Bank of India. 2008. *Annual Report 2008*. New Delhi.

3. Large Unexploited Domestic and Regional Trade Potential

21. While the recent performance is very impressive compared with India's past performance, India has recognized that it trails East Asia in trade performance. The PRC's imports of goods expanded by 50% annually and exports by 53%, while export of services grew 29% yearly and imports of services by 23%. In 2006, India's share of world exports was 1.8%, while the PRC's stood at 7.9%. The PRC's and India's similar size and status as developing countries point to enormous opportunities for India's foreign trade as it improves its competitiveness.

22. **Trade and per capita income.** In the 1990s, the PRC's per capita income doubled; India's increased by only 10% (Table A2.10). Both countries have benefited largely from a buoyant world economy since 2000, boosting per capita income by 155% in the PRC and by 120% in India over only 7 years. The countries' openness and the increase in the incomes of its citizens are strongly associated, pointing to the large potential of trade leading to trickle-down effects to small business, employment, and income through linkages with the manufacturing value chain. Since FY2000, the dollar value of India's labor-intensive exports of agricultural produce have surged at an annual 14% and manufactured goods at 24%, indicating initial integration of rural areas and farmers, as well as small and medium enterprises (SMEs), into the global value chain. Experienced corporate exporters, however, have not yet established large supply networks with small businesses and farmers in rural India. Thus, trade has so far not been fully effective in poverty reduction in rural areas, and especially in the backward and poorer regions of India. This is consistent with the findings of the *Trade and Development Report 2007* (footnote 1), and of the G8,³ G24,⁴ and World Trade Organization (WTO) underpinning the rationale for the Aid for Trade initiative.⁵

Table A2.10: Gross National Income Per Capita in Current Prices
(\$)

Country	1990	1995	2000	2006	2007	2008
People's Republic of China	320	520	890	2,010	2,320	3,000
India	390	330 ^a	450	820	990	1,043

^a 1994 figure.

Sources: International Monetary Fund, World Bank.

23. **South Asia: Inequality and poor infrastructure undermining trade.** The trade of the South Asian economies still falls significantly below that of Southeast and East Asia, as well as the global average. The subregion is characterized by poor connectivity, and limited market access. Limited subregional trade is a result of large nontariff barriers and high protection. Except for Nepal, all trade partners within the South Asian Association for Regional Cooperation (SAARC) have insignificant trade activity.

24. **South Asia: Growing importance in the international value chain.** The trade centrality index illustrates an economy's positioning in global value chains and trade networks. A high trade centrality value (on a scale of 0–100) reflects a central position of influence within key

³ The Group of 8 (G8) is an international forum for the governments of Canada, France, Germany, Italy, Japan, the Russian Federation, the United Kingdom, and the United States.

⁴ The Group of 24 (G24), a chapter of the Group of 77 (G77), was established in 1971 to coordinate the positions of developing countries on international monetary and development finance issues. The G77 is a coalition of developing nations promoting its members' economic interests and negotiating capacity in the United Nations.

⁵ World Trade Organization. 2006. *Aid for Trade*. <http://www.wto.org>.

global supply and value chains. Except for India, with an index of 20, South Asia is still relatively marginally integrated into the global value chain compared with the United States (index of 90), Europe (index of 80), Japan (index of 60), and Thailand (index of 25).⁶

4. Trade Strategy and Policy Reforms

a. Trade Policy

25. **Trade and income growth stimulus.** India recognized the opportunities and challenges associated with the increasing globalization of the world economy in the articulation of its Foreign Trade Policy 2004–2009, which aims to double India’s share in world trade to 2% and generate additional employment through the promotion of labor-intensive exports. India aims to stimulate growth in trade, exploit its labor advantage, and broaden the benefits from trade growth with greater inclusiveness of growth. India’s trade strategy aims to

- (i) rationalize tariffs and tax rebates, and reduce transaction costs;
- (ii) improve the quality and reliability of exports;
- (iii) improve export infrastructure; and
- (iv) expand SME trade finance over the long term.

b. World Trade Organization

26. India, an active member of the WTO, provides “most favored nation” (MFN) status to other members. It stresses the need to address agricultural subsidies in rich countries and tariff and nontariff barriers to exports of developing countries. India has accepted the fourth and fifth protocols and is a member of the Information Technology Agreement.⁷ It is not a party to the WTO Government Procurement Agreement. Like all other WTO members, India is required to make regular notifications of its trade-related laws and measures. It believes that the interests of the 650 million poor who are dependent on agriculture should not be jeopardized, and emphasizes special and differential treatment through lower tariff reduction commitments by developing countries and a list of special products vital to ensuring the livelihoods of poor farmers. For services, India seeks increased market access, especially through the liberalization of professional services.

27. In the current trade negotiations, India has submitted proposals relating to agriculture, nonagricultural market access, services, disputes, competition policy, trade facilitation, rules, trade-related intellectual property rights, and special and differential treatment. A number of these proposals were made jointly with other members and developing countries, including the G20, G33, and nonagricultural market access-11 groups. At the September 2003 conference in Cancun, Mexico, and the December 2005 conference in Hong Kong, China, the Government of India stressed the need to address agricultural subsidies in rich countries, and tariff and nontariff barriers maintained by these countries on products of export interest to developing countries.⁸ It is emphasizing special and differential treatment through proportionately lower overall bound tariff reduction commitments by developing countries, coupled with a special safeguard mechanism and a list of special products vital to ensuring the livelihoods and food security of farmers in developing countries.

⁶ Kali, R., and J. Reyes. 2006. *The Architecture of Globalization: A Network Approach to International Economic Integration*, Working Paper Series 2006.

⁷ India accepted the fourth protocol on 10 November 1997 and the fifth on 9 December 1998.

⁸ World Trade Organization. 2008. WT/MIN (03)/ST/7, 10 September 2003 and WT/MIN (05)/ST/17, 14 December 2005.

c. Regional Trade Agreements

28. Regional trade agreements, besides the WTO, are supplemental building blocks. Since 1975, India has signed a number of agreements, mainly with developing countries to strengthen ties with regional groups, such as the Association of Southeast Asian Nations, the South Asian Association for Regional Cooperation (SAARC), and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC). Current negotiations include strengthening regional ties, for example, through the SAARC and BIMSTEC, but India is also seeking to develop ties with other regional groupings, such as ASEAN and MERCOSUR (regional trade agreement between Argentina, Brazil, Paraguay, and Uruguay). Recent trade agreements, including an agreement with Singapore, go beyond negotiations on goods, to include services and investment.

29. **South Asian Association for Regional Cooperation.** SAARC, an agreement for regional cooperation among Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka, was established in December 1985. In 1993, the SAARC preferential trading arrangement was signed, providing limited preferential market access. The agreement on a South Asia Free Trade Area (SAFTA) was signed during the 12th SAARC Summit in Islamabad in January 2004. The preferences exchanged under SAFTA will continue to be available to members until the tariff liberalization is complete, as targeted for 2008 for nonmembers of the group of least developed countries (LDCs) and for 2012 for LDC members (Bangladesh, Bhutan, Maldives, and Nepal). India has notified 744 import items from LDC members and 865 from non-LDC members; the first tariff reductions took effect on 1 July 2006.

Table A2.11: Commitments under Regional Trade Agreements, 2007

Agreement	Trade in Goods	Trade in Services	Other Areas
SAFTA	Non-LDC members, including India to reduce tariffs to 20% within 2 years, followed by a reduction to 0%–5% in 5 years (6 years for Sri Lanka) and 3 years for imports from LDC members. India has a negative list of 744 import items from LDCs and 865 items from non-LDC members that are excluded from commitments.	Not applicable	Not applicable
Asia-Pacific Trade Agreement (Bangkok Agreement)	Tariff preferences for 570 six-digit tariff lines and an additional 48 tariff lines for LDC members with margin of preference ranging from 5% to 100%.	Not applicable	Not applicable
BIMSTEC	Framework agreement signed in February 2004 to form a free trade area by 2012 with an additional 5 years given to LDC members. Negotiations on trade in goods, expected to be complete by the end of 2005, are ongoing. Negotiations on services and investment are to be concluded in 2007.	Not applicable	Not applicable
GSTP	Tariff concessions of 10%–50% on 53 tariff lines at the HS six-digit level. Tariff concessions of 50% apply to 3 tariff lines and are available for Bangladesh, Benin, Guinea, Haiti, Mozambique, Sudan, and Tanzania.	Not applicable	Not applicable
Special preferential areas	Tariff preferences for certain imports from Mauritius, Seychelles, and Tonga.	Not applicable	Not applicable
Afghanistan	Tariff reductions on 38 HS six-digit tariff lines, with margins of preferences of 50% or 100% of the MFN tariff in force from 13 May 2003.	Not applicable	Not applicable

Agreement	Trade in Goods	Trade in Services	Other Areas
Nepal	Tariff exemptions for all goods subject to rules of origin. Certain goods (vanaspatti copper products, acrylic yarn, and zinc oxide) are subject to annual quotas.	Not applicable	Not applicable
Singapore (CECA)	Zero duty as of 1 August 2005 for 506 HS eight-digit products effective. Phased reduction and elimination of duty by 1 April 2009 for further 2,202 HS eight-digit products and phased reduction of duty by 50% by 1 April 2009 for 2,407 HS eight-digit products. Some 6,500 HS eight-digit products are excluded from duty reductions.	Business, communication, construction, distribution, financial, health, tourism, and transport services	Investment, standards, intellectual property rights, science and technology, education, and dispute settlement
Sri Lanka	Zero duty as of 1 March 2000 for over 1,000 tariff lines and a 50% margin of preference for all other items except 429 items on a negative list. Tariff concessions on textiles are 25% below the MFN rate. Tariff quotas apply to tea and garments and vanaspatti. Import restricted to 250,000 tons per annum.	Not applicable	Not applicable
Thailand	Early harvest scheme for 82 products at the HS six-digit level; tariffs to be reduced in phases from 1 September 2004 and to be eliminated by 1 September 2006.	Not applicable	Not applicable

BIMSTEC = Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation, CECA = Comprehensive Economic Cooperation Agreement, GSTP = Global System of Trade Preferences, HS = high score, LDC = least developed country, MFN = most favored nation, SAFTA = South Asia Free Trade Agreement.

Source: Ministry of Commerce and Industry, Government of India. <http://commerce.nic.in>

30. **Asia-Pacific Trade Agreement.** The Bangkok Agreement was signed by Bangladesh, India, the Lao People's Democratic Republic, the Republic of Korea, the Philippines, Sri Lanka, and Thailand in July 1975; the PRC acceded in April 2001.⁹ The agreement took effect on 1 September 2006.¹⁰

31. **Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation.** Bangladesh, India, Sri Lanka, and Thailand signed the agreement in June 1997; Bhutan, Myanmar, and Nepal joined in 2004. In February 2004, the members signed a framework agreement to form a free trade area by 2012. Although this agreement provides for negotiations to be concluded on goods by December 2005, and on services and investment by 2007, these deadlines have not been met because of complex issues.

32. **Sri Lanka.** India signed a free trade agreement with Sri Lanka in December 1998. Under the agreement, India eliminated tariffs, except for a negative list comprising 429 items including garments, plastics and rubber, alcoholic spirits, and coconut oil.¹¹ India maintains tariff quotas on tea and garments under the agreement, which provides for antidumping and safeguard measures, and the suspension of preferences in case of balance-of-payments difficulties. India and Sri Lanka are currently negotiating a comprehensive agreement to include services trade.

33. **Comprehensive Economic Cooperation Agreement with Singapore.** The agreement, which took effect in August 2005, is the first signed by India that includes services and investments. Tariff concessions were to be implemented by 1 April 2009. The following

⁹ World Trade Organization document. WT/COMTD/N719, 29 July 2004.

¹⁰ United Nations Economic and Social Commission for Asia and the Pacific. 2005. Asia-Pacific Trade Agreement. http://www.unescap.org/tid/apta/ta_amend.pdf

¹¹ Sri Lanka is expected to eliminate its tariffs on imports from India by 2008.

products were excluded: agricultural products, alcoholic beverages, minerals, chemicals, rubber products, and textiles and clothing products (6,551 tariff lines or over half of the tariff). These products will remain subject to MFN duties. Commitments for financial services include life and nonlife insurance, and commercial banking licenses for three banks (DBS Group, United Overseas Bank Limited, and Overseas Chinese Banking Corporation), including up to 15 branches over 4 years. Commitments were made to protect investment, including protection from expropriation and compensation for expropriation. The agreement exempts Singapore investment from capital gains tax.

34. **Framework Agreement for Establishing a Free Trade Area.** The agreement, signed with Thailand in October 2003, covers trade in goods, services, and investment, and specific commitments related to the trade of goods, including the elimination of tariffs on 82 products.

35. **Framework Agreement on Comprehensive Economic Co-operation.** The first ASEAN–India Summit was held on 5 November 2002 in Cambodia, where India committed to special and differential treatment of ASEAN members based on their development, and to align its peak tariffs to East Asian levels by 2005. The framework agreement was signed with ASEAN on 8 October 2003 and includes trade in goods, services, and investments and an “early harvest” program. An India–ASEAN free trade agreement was concluded in August 2008.

36. **European Union Partnership Agreement.** The India–European Union Strategic Partnership was signed on 7 September 2005; a senior trade group was established to identify reforms in trade relations and to negotiate a broad-based trade and investment agreement.

37. **South African Customs Union, Common Market of the South, and others.** India is exploring the possibility of a comprehensive agreement with the Southern African Customs Union (Botswana, Lesotho, Namibia, South Africa, and Swaziland), and has signed preferential agreements with Afghanistan (6 March 2003), the Common Market of the South (MERCOSUR) (19 March 2005), and Chile (8 March 2006). A framework agreement for cooperation in trade in goods and services and investment was signed with MERCOSUR on 25 January 2004. As a first step, India committed on 450 tariff lines ranging from 10% to 100% of the MFN rate. The framework agreement signed with Chile on 20 January 2005 includes 178 tariff lines ranging from 10% to 50% of the MFN rate. The agreements with MERCOSUR and Chile are not yet in force.

38. The bilateral agreement with Nepal was extended up to 5 March 2007, and the free trade agreement with Bhutan, conducted in local currency, was extended on 29 July 2006 for 10 years. The trade cooperation agreement with Bangladesh was extended for 3 years, from 1 April 2006. India also maintains transit agreements with Bangladesh and Nepal. India is negotiating a number of trade agreements with the Republic of Korea, Mauritius, and the Gulf Cooperation Council, and has set up joint study groups to explore the feasibility of comprehensive economic cooperation agreements with Australia, the PRC, Indonesia, Japan, Malaysia, the Russian Federation, and the United States.

d. Tariff and Tax Regime

39. India aims to neutralize the incidence of levies and duties on inputs used in export products, liberalize controls, and simplify export procedures. Although it reduced peak import tariff rates for manufactured goods from more than 200% in 1990 to 10% in 2007, import tariff remains its main trade policy instrument as well as an important source of tax revenue, constituting 16% of central government tax revenue.

40. Applied MFN tariffs, especially for nonagricultural products, have continued to fall steadily, with the overall average currently at 16%. At 12% (14% including ad valorem equivalents), the average for nonagricultural products is considerably lower than the average for agricultural products, which is 41%. With the exception of a few applied tariffs, which are at their corresponding bound rates, the difference between the bound and applied tariff rates is considerable, giving the Government substantial discretion to raise applied tariffs. This was used to raise tariffs for some agricultural products in recent years. The overall trend in tariff rates is downward and, in its FY2008 budget, the Government announced a reduction of the peak rate from 12.5% to 10%. Despite gradual reform over the years, the tariff remains complex; tariff changes are announced throughout the year and with numerous exemptions, a number of which are based on industrial use.

41. India offers tariff preferences under regional trade agreements. However, apart from the agreement with Sri Lanka and some members of the SAFTA, the preferences do not appear to be significant. The use of import restrictions has declined, with around 3.5% of tariff lines subject to such measures. Another 300 sensitive imports are monitored, while the policy for state trading remains essentially unchanged.

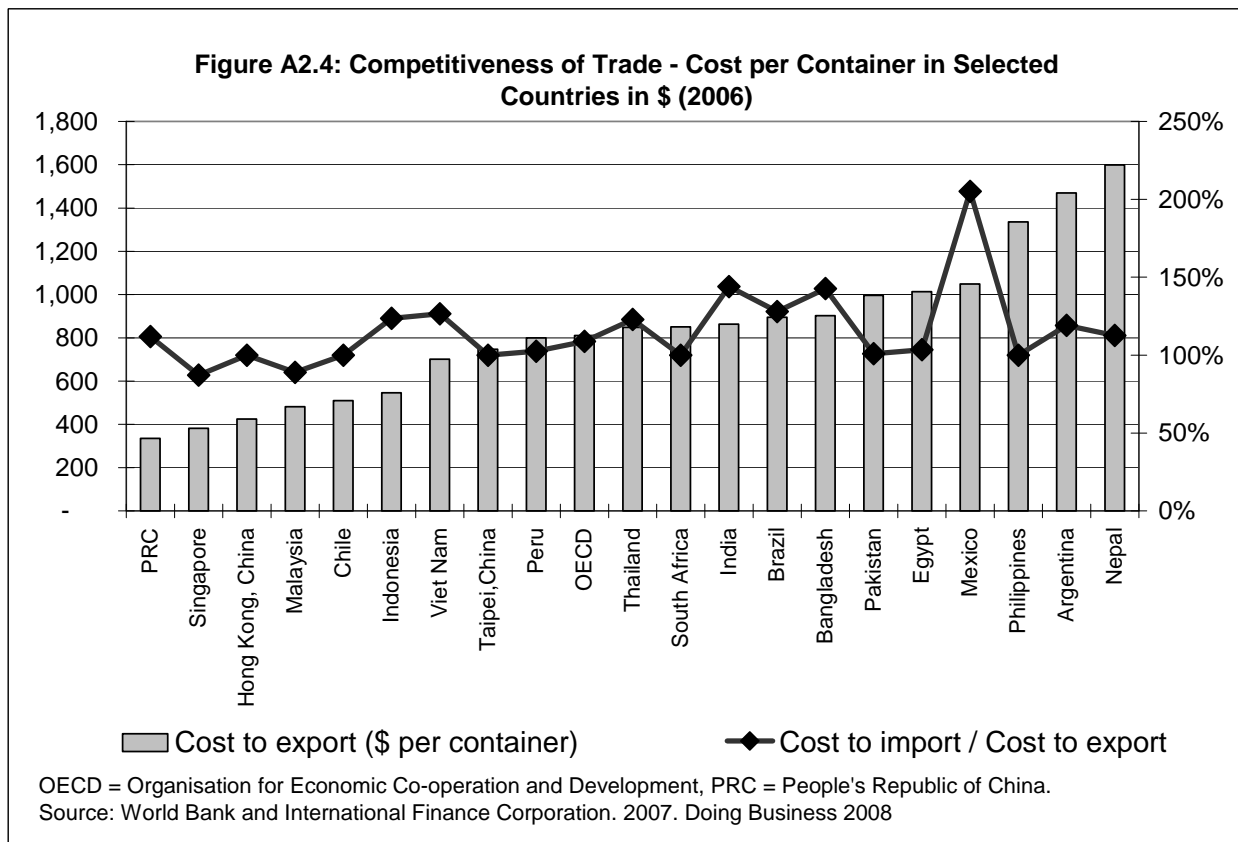
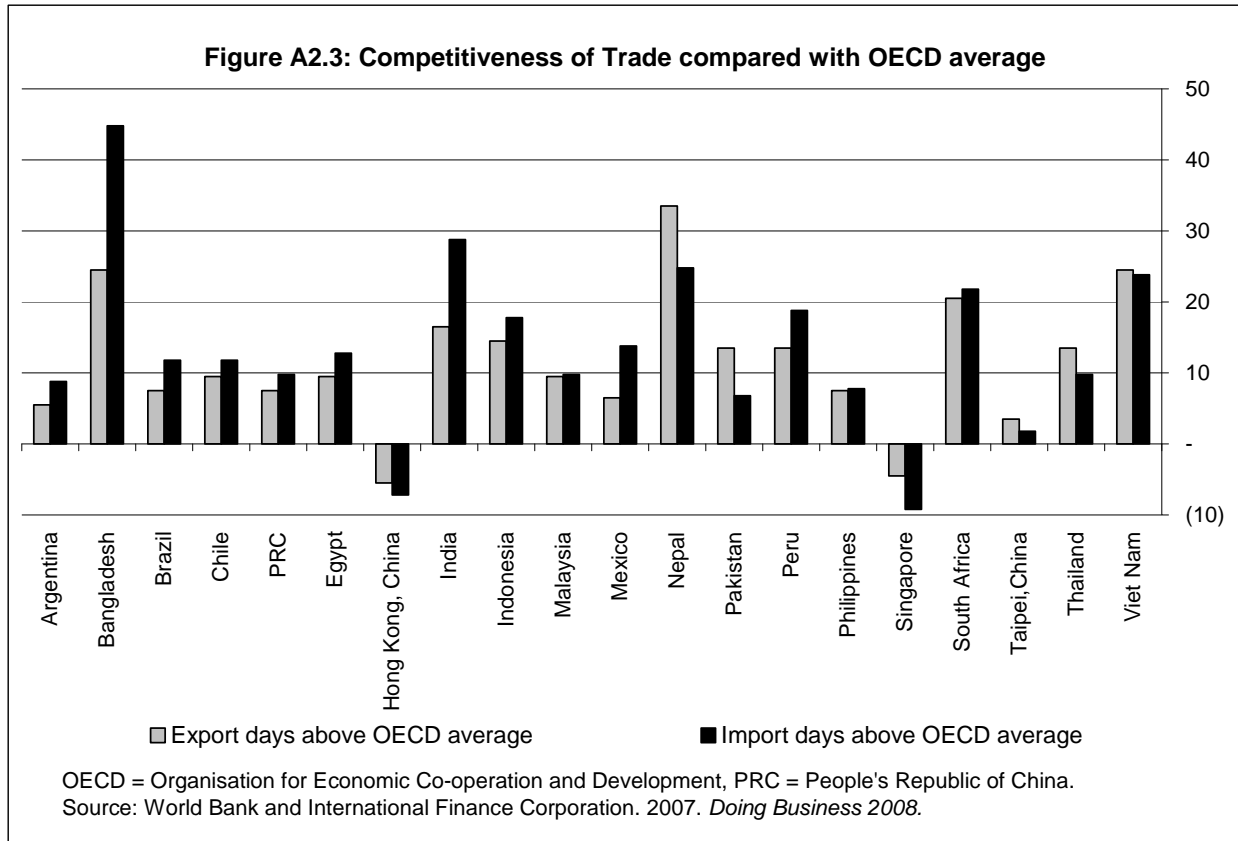
e. Transaction Costs

42. Industrial policy reforms have concentrated on simplifying and reducing restrictions. The number of sectors requiring compulsory industrial licensing for safety, environmental, and strategic reasons has been reduced from six to five, while the number of items reserved for production by small-scale industries has declined substantially, from 799 in 2001 to 326 in May 2006. However, as a result of cumbersome documentation, especially for imported goods, India is behind its competitors.

43. Efforts to increase competition have been aided by the introduction of new legislation to encourage competition and to ease the closure of unviable companies. The new laws include the Competition Law, and the Micro, Small, and Medium Enterprises Act, passed in 2006 to encourage the development of these businesses. Progress has been made in improving corporate governance, notably through improved listing requirements for listed companies and banks; in addition, efforts are under way to amend the Companies Act of 1956, to increase transparency and accountability.

44. **Product standards and procedures.** India undertook a considerable effort to align national product standards with international norms; now 73% of national standards are aligned. Sanitary and phytosanitary procedures were streamlined with the passage of the Food Safety and Standards Act of 2006 consolidating 13 laws.

45. Figures A2.3 and A2.4 illustrate the high cost of doing business for exports and, even worse, for imports at Indian ports. The import process is cumbersome as a result of the large number of protected items, which puts Indian firms at a disadvantage in relation to its international competitors.



46. **Customs procedures.** To enhance competitiveness with neighbors, improved trade flow among South Asian countries is important at land border crossings. Trade continues to suffer from cumbersome regulations, security clearance, and certification. The cost of cross-border trade in South Asia is still extremely high as a result of delays, corruption, and the absence of harmonized and streamlined customs procedures.

f. Trade Infrastructure and Logistics

47. The development of transport corridors and associated trade logistics is critical for timely and cost-effective turnover of goods. The corridors of Delhi–Mumbai, Delhi–Gujarat, Bangalore–Chennai, Kathmandu–Birgunj–Kolkata–Haldia, and Thimpu–Kolkata are being developed. The coordinated performance of the route and logistics services is critical. The selection of routes depends on the characteristics of goods shipped, as well as the sensitivity of market demand to time and cost. For example, high-value cargoes are usually more time than cost sensitive.

48. Private operation of transport and logistics services has provided significant gains in efficiency. The public sector continues to be an important provider of rail and air transport as well as transport infrastructure. High-volume corridors, such as Delhi–Mumbai, allow for faster turnaround, better freight planning, and better load factors. Concor, a public–private joint venture (37% owned by the private sector, 63% by Indian Railways) has been successful in providing container train services on key corridors, notably Delhi–Mumbai. The logistics industry in India has increased its capacity to track and trace services, which are currently limited to frequented corridors linking the major economic centers of India, while low-volume corridors cannot effectively handle containers and seamless transfer and reconsolidation facilities.

49. With the strong growth in trade, India has experienced dramatic growth in international container traffic, pushing port capacities to the limit. Trade gateways for India and neighboring SAARC countries include seaports, airports, and land border crossings. These gateways suffer from a significant regulatory burden associated with customs and security. Certification and the cost of cross-border trade in South Asia and SAARC rank highest in the world.

50. Improved infrastructure and logistics services of roads, ports, and airports are essential to integrate India's exporters into the global value chain and improve competitiveness. Private investors and service providers are encouraged to participate in financing, construction, and maintenance of infrastructure. Private operation of transport and logistics services has resulted in significant efficiency gains. While the public sector remains an important provider of rail and air services and transport infrastructure, reforms to increase the turnaround of goods are gradually being introduced. India's container-handling costs at its ports compare unfavorably with key competitors. Also, Indian export goods normally require double the handling time at the port. The Government estimates investments in transport infrastructure alone at \$150 billion over the next 5 years.

g. Overall Performance and Export Contribution of the Small and Medium Enterprise Sector

51. Encouraging the development of SMEs is a strategy particularly well suited to India's development challenges. SMEs are typically less capital intensive and more labor intensive and

therefore best suited to countries like India, the PRC, and most other developing countries with an abundant supply of low-cost manpower and bountiful natural resources.¹²

52. According to a survey conducted by the Ministry of Micro, Small and Medium Enterprises, the number of small-scale industry (SSI) units in India has increased, from 10.95 million in 2002–2003 to 12.8 million (registered and unregistered) in 2006–2007.¹³ Around 81% of these units are proprietorships and the remaining 17% are partnerships and private limited companies. Investment in fixed asset grew by 5% from Rs1,625 billion (\$39.67 billion) in 2002–2003 to Rs2,073 billion (\$50 billion) in 2006–2007. About 8,000 products were manufactured, with values increasing from Rs3,120 billion (\$76.55 billion) in 2002–2003 to Rs8,160 billion (\$200 billion) in 2006–2007. Industry groups with a large share in the total production of SSI units—textile products, wood, furniture, paper, printing, and metal products—all recorded high growth. Table A2.12 below summarizes the overall performance of the SSI sector.

Table A2.12: Performance of Small-Scale Industries Sector

Year	Units (million)	Production (Rs billion)		Employment (million)	Production per employee	SSI Exports	
		At 1993–1994 Prices	At current prices (2002–2003)		At 1993–1994 Prices (Rs'000)	Rs billion	\$ billion
1990–1991	6.79	682.95	635.18	15.83	43	96.64	2.37
1995–1996	8.28	1,216.49	1,482.90	19.79	61	364.70	8.95
1996–1997	8.62	1,353.80	1,684.13	20.59	66	392.48	9.63
1997–1998	8.97	1,478.24	1,891.78	21.32	69	444.42	10.90
1998–1999	9.34	1,594.07	2,129.01	22.06	72	489.79	12.02
1999–2000	9.72	1,707.09	2,342.55	22.91	75	545.00	13.37
2000–2001	10.11	1,844.28	2,612.89	23.91	77	697.97	17.12
2001–2002	10.52	1,956.13	2,822.70	24.91	79	712.44	17.48
2002–2003	10.95	2,106.36	3,119.93	26.01	81	860.13	21.10
2003–2004P	11.40	2,287.30	3,577.33	27.14	83	—	—
2004–2005P	11.85	2,457.47 ^a	3,990.20	28.28	87	—	—
2004–2005	11.86	3,729.38	—	28.76	130	1,244.00	27.70
2005–2006	12.34	4,188.84	—	29.58	142	1,500.00	33.90
2006–2007P	12.84	4,716.63	8,160.00	31.25	151	—	—

— = no data available, P = provisional, SSI = small-scale industries.

Note: Data have been revised since 1990–1991 on the basis of the findings of the Third All-India Census of SSI Units.

^a = Based on the growth rate of 7.44%, which is the average growth of last year.

Sources: Ministry of Micro, Small and Medium Enterprises, Government of India; Ministry of Small-Scale Industries, Government of India, Annual Report 2005–2006.

53. At present, the SME sector contributes nearly half of India's total exports, out of which, nearly 35% comprises direct exports while the remaining 15% takes the form of indirect exports through merchant exporters, trading houses and export houses, wholesalers, and lead firms along incipient value chains. Active export sectors like clothing, gems, jewelry, leather, and marine products are dominated by SME units. In export orders from large units, SME units also support large manufacturers or supply parts, components, and subassemblies for use in finished goods for exports. The volume of SSI exports increased 14 times from \$2.37 billion in 1990–1991 to \$33.9 billion in 2005–2006 (Table A2.12).

¹² The PRC's 42 million SMEs account for 99% of all enterprises and provide 75% of jobs in the urban areas. Thus, the PRC Government is implementing a special law to promote and protect these units.

¹³ According to estimates (RBI 2005), the SME sector consists of 12.3 million enterprises employing 29.5 million people.

C. Short-Term and Long-Term Trade Finance

1. Context of Globalization

54. **Trade finance.** While improving the trade environment is a challenging task, the Government has appropriately identified areas for trade reform and is gradually addressing them. More importantly, it has identified the growth potential of emerging markets, especially in Asia, and is making active use of the demand stimulated in these regions. Trade finance instruments are essential for the effective growth of trade.

55. **Convergence of financial sector standards.** India is undertaking substantial efforts to harmonize its standards with internationally acceptable norms, to combat money laundering and terrorist financing, and to introduce Basel II.

56. **Underdeveloped markets for export finance segments.** The experience of many developed and developing countries suggests that commercial banks are capable of providing short-term trade finance (especially post-shipment finance) for manufactured goods and services, given the short-term financing need, which normally does not exceed 180 days from the shipment of the good. Pre-shipment finance is riskier because the production of goods may require longer production and prefinancing periods. The financing of exports and imports of capital goods is normally challenging for commercial banks since the long gestation period requires financing of tenors that do not easily match their funding structure. Export markets, especially emerging markets, are associated with high credit risk because of uncertainty and information asymmetry over legislation, political stability, and business practices in the destination countries.

2. Role of the Export-Import Bank of India and Commercial Banks

57. Trade financing in India is governed by the Foreign Exchange Management Act and directives issued by RBI. Typical export credits, i.e., pre-shipment and post-shipment credits, are the customary banking credit facilities used by exporters in India. Exports of commodities and manufactured products, where foreign exchange is realized or payments made typically within 180 days from shipment date, require short-term finance, while exports of capital goods, services, and turnkey projects require medium-term (1–5 years) and medium- to long-term (beyond 5 years) loans. Commercial banks, with their short-term liability structure, concentrate on traditional short-term trade finance. Exim Bank offers export refinancing to commercial banks. Exim Bank is expanding its role in export finance (Table A2.13).

Table A2.13: Exim Bank Investment in Aid for Trade to Address Market and Governance Failures

Broad Source or Area of Failure	Examples of Failures	Policy and Activity Responses	Role for Aid for Trade	Role for Multilateral Finance
Market failures Coordination	Externalities ignored Linkages not exploited Complementarities not exploited	Capacity building for SME to identify production chain linkages and externalities	Yes, training and institutional development, market development programs	TA finance (grant, loan)

Broad Source or Area of Failure	Examples of Failures	Policy and Activity Responses	Role for Aid for Trade	Role for Multilateral Finance
Developing, adapting and adopting technology, standards, financial extension, BDS	Incomplete and imperfect information Network externalities	Facilitate technology transfer and adoption. Support for quality control to meet export standards	Yes, trade facilitation investment with the private sector	Long-term finance (NSO)
Access to finance provided by commercial banks as a means of payment between importers and exporters for pre-shipment, post-shipment is restricted	Difficult access to credit High interest rates	Credit schemes	Normally not included under Aid for Trade	Short term (TFFP) ^a
Trade facilitation infrastructure (logistics, communications, economic hubs and zones, corridor infrastructure, boarder infrastructure, overseas market access depots and infrastructure, etc.)	Lack of good quality trade facilitation infrastructure because lumpy investment gets postponed in uncertain times	Provide incentives for public-private partnerships Provide loans in the case of low financial return and high economic return	Yes, aid to economic infrastructure and better coordination with government and private sector	Long-term finance (NSO and/or sovereign)
Governance failure Regulatory and administrative structure	Burdensome administrative requirements.	Streamline administrative procedures and regulation	Yes, trade policy and regulations (especially trade facilitation).	Medium-term adjustment finance (sovereign)

BDS = business development services, NSO = nonsovereign operation, SME = small and medium enterprise, TA = technical assistance, TFFP = trade finance facilitation program.

^a Jongwanich, J., W. James, P. Minor, and A. Greenbaum. 2009. Trade Structure and the Transmission of Economic Distress in the High-Income OECD Countries to Developing Asia. *Asian Development Review*. 26 (1). Manila: Asian Development Bank.

Source: Asian Development Bank.

58. **Stimulus for trade and export finance to emerging markets.** Because of the prevalence of high risk in export finance, most successful exporting countries have established specialized public sector financial institutions to ensure that trade and export finance is provided where the market is unable or unwilling to provide that service. The financial institutions normally take the form of export credit guarantee agencies and specialized banks that focus on mitigating the commercial risk for funding exports to emerging markets and longer-tenor structures. Contrary to conventional perception, privately owned structures have proved less successful at spearheading export finance into new markets. Export finance in new emerging markets is normally facilitated by bilateral or multilateral government-to-government agreements that provide legal protection and implicit political risk guarantee to exporters.

59. Trade finance is provided by commercial banks and Exim Bank to exporters in national and foreign currency. Scheduled commercial banks are required to lend 12% of their business for exports. In March 2006, 19% of foreign banks loans outstanding constituted export credit.

60. **Exim Bank to develop export markets and leverage export finance.** Consistent with international good practice, the Government established Exim Bank to spearhead export finance

in areas where the market is not developed by commercial banks. While the volume of bills discounted by commercial banks is limited, at about 2% of bank credit outstanding, commercial banks' export credit has more than doubled since FY2003 to about Rs1.1 billion in FY2007, but its share in overall bank credit has decreased from about 8% to 6% of outstanding commercial bank credit.¹⁴ During the same period, Exim Bank doubled its share of overall export credit from 4% to 8%. The demand for foreign currency financing of export credit increased, concurrent with exporters' modernization efforts, shifting the proportion of foreign exchange-financed export credit in a single year (FY2005) from about 15% to 40%. In addition, India received massive foreign funding, amounting to \$27.7 billion during the 12 months until May 2007.¹⁵

Table A2.14: India Export Credit Outstanding

Item	FY2003	FY2004	FY2005	FY2006	FY2007
Commercial bank export credit (Rs billion)	430	492	691	862	1,113
Average annual growth (%)		1	40	20	25
Share of export credit to total credit (%)	8	7	6	6	6
Exim Bank export credit (Rs billion)	22	37	39	67	89
Export credit share of Exim Bank (%)	4	6	5	7	8

FY = fiscal year.

Source: Export-Import Bank of India.

3. Banking Reform in the Context of Globalization

61. **Coordinated approach to bank risk management (Basel II).** The globalization of the world economy is posing increasing demands to upgrade capability and risk management systems to facilitate cross-border finance and bring these in line with international standards. The Government recently established a blueprint for an international financial center in Mumbai to accommodate India's integration into the financial markets. It has also taken the following steps to introduce the new Basel II risk management framework for banks in India. As a participant of the Basel Committee on Banking Supervision, RBI has recognized the need (i) to reform the capital adequacy framework to take into account the globalization of financial services, and (ii) to emphasize the importance of good board and prudential supervision including management understanding of the banks' inherent risks when defining minimum capital.

62. On 27 April 2007, RBI prescribed, in line with the International Convergence of Capital Measurement and Capital Standards (a revised framework),¹⁶ the so-called Basel II framework, its Guidelines for the New Capital Adequacy Framework.¹⁷ RBI is taking a gradual approach that requires all commercial banks in India (excluding local area banks and regional rural banks) to adopt the standardized approach to managing credit risk and the basic indicator approach to operating risk by 21 March 2009, and to continue to apply the standardized duration approach when computing capital requirements for market risks. Foreign banks operating in India and Indian banks with operations outside India had to comply with the new framework by 31 March 2008.¹⁸

63. To facilitate the transition to the new framework, since 2006 all banks have been required to prepare parallel statements under the current and new frameworks to encourage the

¹⁴ 10% in FY2000.

¹⁵ Reserve Bank of India statistics on external commercial borrowing. 2007.

¹⁶ See framework issued on 30 June 2006 at www.bis.org.

¹⁷ See RBI/2006-2007/357 DBOD. No. BP. BC. 90 / 20.06.001/ 2006-07 issued on 27 April 2007 at www.rbi.org.in.

¹⁸ These refer to pillar 1 (capital adequacy) and pillar 3 (transparency and disclosure) of the Basel II framework.

streamlining of their risk management systems and business strategies. Pillar 2 of the Basel II framework requires banks' boards to undertake compliance assessments; establish policies for credit risk mitigation, disclosure, and internal capital adequacy assessment; and assess the banks' management information systems for compliance with the standard under the new framework.

64. RBI will consider relevant risk factors and the internal capital adequacy assessments in setting an adequate bank capital requirement that is commensurate with its risk profile. This includes the capability of risk management to identify, assess, measure, and manage interest rate risk, liquidity risk, concentration risk, residual risk, and other banking risks.

65. **Basel II to facilitate flow of resources for trade finance.** While Exim Bank is not required to comply with the RBI regulations, it has done so voluntarily over the years to underscore a professional standard at par with the rest of the banking subsector. It has consistently taken steps to improve its risk management according to the Basel II framework. However, considering the anticipated trend in trade funding needs in more-challenging emerging markets, a more fundamental review of Exim Bank's business model is needed to align it effectively with changing market needs and requirements for more-effective risk management. Technical assistance will assist Exim Bank in this process.

ENVIRONMENTAL AND SOCIAL MANAGEMENT SYSTEM FRAMEWORK

A. Guiding Principles

1. The globalization of the world economy is posing increasing demands to upgrade the capability and risk management systems to facilitate cross-border finance and bring these in line with international standards. It is expected that India's exporters will face rising quality standards for exports of their goods, especially to industrialized and newly industrializing economies. Among the standards to be met in the manufacturing and value-addition process are core labor standards, as well as environmental and social safeguards that increase the need to meet the standards and legislation of the importing countries. The recent discussion of environmental monitoring of industries and product monitoring of food, toy, and service exports illustrates the issue. While legislation exists in many countries, domestic enforcement is often weak and often does not meet the standards of international-quality audits. The Export-Import Bank of India (Exim Bank) will review its overall risk management process in the context of the proposed facility to be funded by the Asian Development Bank. It will formulate a corporate policy for environmental and social management. The guiding principles will be

- (i) compliance of Exim Bank with applicable environmental, social safeguard, and land acquisition and resettlement laws and standards;
- (ii) integration of environmental and social safeguard aspects of investments into the due-diligence process and independent credit risk review;
- (iii) regular exchange with leading export finance and export credit and insurance agencies and professional groups like the Organisation for Economic Co-operation and Development on the application of environmental best practice in trade finance;
- (iv) establishment of an environmental and social (including resettlement) screening, classification, and assessment system to identify and monitor adverse environmental and social impact associated with its business activities, wherever deemed necessary for projects supported in importing countries;
- (v) identification of appropriate mitigation and compensation measures to minimize adverse impact in line with international standards;
- (vi) public disclosure of environmental and social impact information in the review process;
- (vii) promotion of customer compliance with applicable environmental and social safeguards, including resettlement laws and standards in India and relevant export destination countries, through appropriate documentation of environmental and social impact studies, approvals by authorities, and site visits;
- (viii) consultations with key stakeholders including affected people and nongovernment organizations concerned;
- (ix) where applicable, prompt interaction with the client in the case of violations of relevant laws and standards, to prepare a corrective action plan; and
- (x) appropriate staffing of Exim Bank's risk management unit and operational departments, and the preparation of annual action plans for the development and operation of the environmental and social management system (ESMS).

B. Environmental and Social Management System

2. Exim Bank will establish and adopt an ESMS to be approved by its board, comprising an ESMS policy, ESMS procedures, and ESMS capacity building plan. In due course, Exim Bank will submit a detailed description of its ESMS.

3. **Environmental and social management system policy.** As part of the process of establishing an ESMS, Exim Bank will prepare and adopt an environmental and social safeguard policy statement to the effect that (i) it will actively encourage and require its customers to observe all applicable environmental and social requirements, and (ii) if the relevant business activities of a customer contravene applicable environmental and social safeguard requirements, it will take action to understand the reasons for noncompliance and will discuss with the customer corrective actions acceptable to the relevant authorities.

4. **Environmental social management system procedure.** Before providing any loans funded under the loan to a customer, Exim Bank will verify that the proposed business activity is not on Asian Development Bank's list of prohibited investments. Exim Bank will undertake an initial assessment of whether the relevant business activities of the customer (including, where appropriate, the project in the importing country for which assistance of Exim Bank has been requested), in the reasonable opinion of Exim Bank, have the potential for adverse environmental or social impact, or may involve land acquisition or involuntary resettlement, or affect indigenous people.

5. If Exim Bank determines that the relevant business activities of the customer may have a potential significant adverse environmental or social impact or may involve involuntary resettlement or affect indigenous people, it will, prior to providing any financial assistance:

- (i) Consult with and assist in providing advisory or other services to the client;
- (ii) Undertake an assessment as part of the lending or investment due-diligence process to satisfy itself that the relevant business activities of the customer comply with all applicable environmental and social requirements.
- (iii) Where the relevant business activities of the customer constitute a category A project¹ or category B project,² undertake an environmental assessment that addresses the following key environmental and social issues:
 - (a) environmental and social conditions of the investment;
 - (b) requirements under relevant laws and regulations, and applicable international agreements, including but not limited to laws and regulations governing land acquisition, compensation, resettlement, and indigenous people;
 - (c) sustainable development and use of renewable natural resources;
 - (d) protection of human health, cultural properties, and biodiversity, including endangered species and sensitive ecosystems;
 - (e) socioeconomic impact;
 - (f) land acquisition and land use;
 - (g) impact on indigenous peoples and communities;
 - (h) cumulative impact of existing, proposed, and anticipated future investments;
 - (i) participation of affected parties in the design and review of mitigation and rehabilitation measures;
 - (j) consideration of environmentally, socially, and economically feasible alternatives;
 - (k) efficient production, delivery, and use of energy; and

² A project is classified as category B if its potential environmental and social impact is less adverse than that of category A projects. Typically, the impact is site specific, rarely irreversible, and can be redressed by readily available mitigation measures.

- (l) pollution prevention and waste minimization, pollution controls (liquid effluents and air emissions), and solid and chemical waste management.

6. In the event that “greenfield” development or significant expansion is involved, the Exim Bank credit committee will determine whether land acquisition and involuntary resettlement may be involved. If it is not able to reasonably satisfy itself that the relevant business activities of the customer comply with all applicable national environmental and social requirements and that involuntary resettlements are not involved, Exim Bank will

- (i) decline to provide funding to such customer; or
- (ii) offer funding and associated services, subject to the condition that the customer shall implement an agreed corrective action plan within a specified period of time; or
- (iii) if possible involuntary resettlement cannot be avoided, require the prospective borrower to prepare and submit a resettlement plan prepared in accordance with this policy as outlined under section. This plan will need to satisfy Exim Bank that resettlement is minimized and that affected people will receive appropriate compensation. During the implementation of the investment Exim Bank will (a) monitor the implementation of the resettlement plan, and (b) distribute status reports as committed to under the plan.

7. **Environmental and social management system capacity.** ESMS will be established through

- (i) integration of environmental and social safeguard aspects in the appraisal, approval, and monitoring process;
- (ii) adequate staffing of Exim Bank’s risk management unit and operational groups; and
- (iii) operation of the credit committee as the decision-making and reviewing authority for the ESMS.

8. **Reporting.** Exim Bank will prepare an annual report, in respect of loans extended under the facility, summarizing

- (i) environmental and social impact of investments supported by it, including the progress of each investment subject to a resettlement plan;
- (ii) any areas of noncompliance or other issues arising from the environmental and social safeguards, including resettlement, and prospective investments where such policies may be triggered; and
- (iii) periodic reviews of the ESMS, for continuous improvement.

TECHNICAL ASSISTANCE TO THE SMALL AND MEDIUM ENTERPRISE TRADE FINANCE DEVELOPMENT FACILITY

1. Established in 1982, the Export-Import Bank of India (Exim Bank) has the mandate to support the Government's foreign trade policy in providing trade finance. Despite its policy role, Exim Bank has shown remarkable independence and commercial orientation in its business, as highlighted by its moderate profitability, improving asset quality, and favorable cost-income ratio.

2. Considering India's large increase of trade since FY2001, which is expected to continue into the foreseeable future, the anticipated further emphasis on India's south-south trade with emerging markets, rapidly rising product standards for trade, and growing cross-border finance in the context of the globalization of value chains, Exim Bank's currently successful operating business model needs to be reviewed to meet the following challenges:

- (i) The surge in demand for trade finance has spurred a level of asset growth that is pushing Exim Bank toward the limit of the absorptive capacity of its current business model. If unchecked, the growth in business may translate into asset quality problems.
- (ii) The current line-of-credit facilities, which entail 100% risk on the part of the Government, are a comfortable but inefficient use of resources to fund trade with riskier emerging markets. Government resources will remain tight under fiscal prudence imperatives and the social spending priorities of the Government.
- (iii) The traditional short-term trade finance business will increasingly come under pressure from commercial banks, which have more attractive funding structures through deposits and an extensive branch network, and there appears to be limited value added in providing classical refinance.
- (iv) Exim Bank alone will not be able to provide the massive funding required to support export finance in the future.
- (v) The current breakup of business units needs to be reviewed to minimize overlap, and consideration must be given to the needs of the regional and industry client focus mapped in Exim Bank's organization chart.
- (vi) Consistent with good industry practice, a chief risk officer needs to report to top management and the board to minimize conflict of interest that may arise in the loan underwriting process, and Exim Bank needs to implement the Basel II framework to remain a highly rated institution.
- (vii) To promote its clients' continued competitiveness and maintain their status as good credit risk Exim Bank needs to enter into active dialogue with its clients on how to meet rising product standards in terms of public health, labor, environmental, and social safeguards in line with the Organisation for Economic Co-operation and Development consensus reached among leading export credit agencies, with which Exim Bank is affiliated.

3. Exim Bank's current Medium-Term Business Strategy 2009-2012 is embedded in the Government's trade policy and strategy, and foresees its leading role in opening new export markets and deepening the funding of value chains originating in India through appropriate export finance instruments for domestic small and medium enterprise (SME) exporters and their international partners. Exim Bank anticipates a continued high need for financing in foreign exchange (outstanding foreign currency loans constituted 45% of the total loans outstanding as of 31 March 2009), to accommodate the need for faster modernization of manufacturing processes and services. Exim Bank also aims to broaden its income and maintain its profitability

by enhancing the scope for fee income for guarantees and advisory services, and improving the efficiency of treasury operations.

4. Exim Bank needs to address in a more fundamental way the issues highlighted above to meet the changing needs of India's external trade and trade finance in particular.

5. **Impact and outcome.** The proposed capacity development technical assistance (CDTA) will make a major contribution to support Exim Bank, the executing and implementing agency for the TA, in undertaking a review of its business model, and subsequently developing and implementing a strategy and associated policies to position itself as a leading export financier in the globalizing trade environment. The following will be taken into account: changing market demand; supply of commercial trade and project finance; environmental, social, and product quality standards; and requirements associated with introducing the Basel II risk management framework.

6. The TA will overcome current obstacles to the competitiveness of SMEs in the global value chain by enabling a business environment conducive to the growth of trade (impact of the TA). It will increase access to financing for firms and projects especially in lagging regions (expected outcome of the TA). This will have a positive affect down the line as investors gain more experience and can be brought in to increase financing for SMEs and projects.

7. **Change management team.** Consistent with international good practice in business strategy and change management, Exim Bank will establish and fully resource a dedicated team of professionals with a full-time, professionally staffed, and appropriately housed project management unit at Exim Bank. The unit head will report to the chair and managing director and to the board, who will establish a strategy oversight committee for periodic feedback to the unit and the consulting team to be recruited under this TA. International experience suggests that the establishment and appropriate sourcing of the leadership team is critical to ensure good understanding of the realities of the organization, maximize understanding and support of staff through effective communication and feedback, and ensure top management ownership of the strategy and its implementation.

8. **Consulting team.** An international consulting firm with either a presence or a competent business partner firm in India will collaborate with the project management unit and report to the top leadership. To qualify for the short listing, the firm must demonstrate the successful completion of relevant change management projects with banks in Asia. The firm must have in-house expertise in formulating and executing bank change management, global trade finance, value chain analysis and development, project finance, and associated corporate environmental and social responsibility systems, and in appropriately staffing and supervising similar projects. The firm will provide a team of experienced international (about 33 person-months) and national consultants (about 70 person-months) over an overall period of 36 months from the signing of the consulting agreement. The consulting team will collaborate day-to-day with the project management unit. Its findings and recommendations will be vetted by a quality review panel of the firm before they are presented to Exim Bank's top management and board.

9. **Recruitment.** Concurrent with the establishment of the project management unit at Exim Bank, the Asian Development Bank (ADB), in close collaboration with Exim Bank management, will start recruiting consultants to implement the services. The quality-based selection method will be used, as it is the most suitable method because of its innovative and flexible approach. To ensure appropriate response, the invitation to submit expressions of interest will be

advertised for 30 days, and the request for proposals, for 45 days. The consulting firm will begin work within 6 months of the initial advertisement of the TA, to allow time for the evaluation of expressions of interest and the subsequent evaluation of proposals and contract negotiations in close collaboration with Exim Bank.

10. **Implementation.** The TA will be implemented over 36 months from the date of the consulting contract. Implementation will include the following broad scope, to be finalized in the context of the recruitment process:

- (i) identification of broad strategic priorities based on an analysis of India's trade and trade finance environment, and identification of specific gaps to be addressed;
- (ii) review of Exim Bank's existing business model and risk management systems including environmental and social safeguards;
- (iii) benchmarking with best practice (international Exim finance agencies);
- (iv) agreement with top management on the gaps to be addressed and on the broad parameters of a new corporate strategy to effectively fulfill its mandate;
- (v) preliminary design of a new business strategy including modified lending and risk management policies and procedures, and establishment of Exim Bank's environmental and social management system (Appendix 4) as well as associated information systems user requirements;
- (vi) procurement or modification of information systems (funded by Exim Bank);
- (vii) pilot-testing and staff training of the modified processes and systems, including information technology as appropriate;
- (viii) after review of top management, final design of new business and risk management, and corporate environmental and social responsibility, policies, procedures, and systems; and
- (ix) rollout of the strategy and business plan and training of staff. The business plan will include, but not be limited to, the preparation of pre-feasibility and feasibility studies for investment.

11. **Costs and financing.** The costs of the TA are estimated at \$2.55 million equivalent. ADB will provide \$1,550,000 equivalent on a grant basis from its TA Special Fund. Exim Bank will provide the balance of \$1 million equivalent for the staffing of the project management unit, office accommodation, logistical support, and required equipment for office and information systems. Any private sector party receiving (direct or indirect) support under this TA will have to provide matching funds from its own resources.

Table A4: Cost Estimates and Financing Plan
(\$'000)

Item	Total Cost
A. Asian Development Bank Financing	
1. Consultants	
a. Remuneration and per diem	
i. International consultants	900
ii. National consultants	390
b. International and national travel	100
2. Contingencies (10% of 1)	160
Subtotal (A)	1,550
B. Exim Bank Financing	
1. Staff salaries	300
2. Staff training and travel	50
3. Office expenses, training facilities, and logistical support	100
4. Computer hardware and software	550
Subtotal (B)	1,000
Total	2,550

^a Financed by the Asian Development Bank's Technical Assistance Special Fund (TASF—other sources).

Source: Asian Development Bank estimates.

SUMMARY OF POVERTY REDUCTION AND SOCIAL STRATEGY

Country/Project Title: India: Small and Medium Enterprise Trade Finance Development Facility

Lending/Financing Modality:

Others: Nonsovereign

Department/ Division:

South Asia Department (SARD)/Financial Sector, Public Management and Trade Division (SAFM)

I. POVERTY ANALYSIS AND STRATEGY			
A. Linkages to the National Poverty Reduction Strategy and Country Partnership Strategy			
The Facility supports the poverty reduction development goals of the Government and the Asian Development Bank for India.			
B. Poverty Analysis: No		Targeting Classification: General Intervention	
1. Key Issues			
The proposed nonsovereign lending to Export-Import Bank of India (Exim Bank) seeks to enhance overall trade development in India. Globalization and the rebalancing of trade toward Asia provides new opportunities for the economic development of India through greater integration into the world economy. India's efforts to integrate into the world economy have led to an impressive surge in international trade since the early 1990s. The ratio of international trade to gross domestic product doubled from 19% in 1991 to 48% in 2008. The Foreign Trade Policy 2004–2009 targets an increase in exports to \$180 billion by 2009 from \$79 billion in 2004.			
2. Design Features. No specific design features are required. Trade finance has proved to have significant trickle-down effects on per capita income in India and other developing countries, as highlighted in the <i>Trade and Development Report 2007</i> of the United Nations Conference on Trade and Development (Appendix 1 provides details).			
II. SOCIAL ANALYSIS AND STRATEGY			
A. Findings of Social Analysis: None.			
B. Consultation and Participation			
1. Extensive due diligence was undertaken through a consultant.			
2. What level of consultation and participation (C&P) is envisaged during the project implementation and monitoring? <input checked="" type="checkbox"/> Information sharing <input type="checkbox"/> Consultation <input type="checkbox"/> Collaborative decision making <input type="checkbox"/> Empowerment			
3. Was a C&P plan prepared? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No			
C. Gender and Development			
1. Key Issues. None. Exim Bank's lending policies ensure appropriate access to credit by male and especially female entrepreneurs.			
2. Key Actions. None <input type="checkbox"/> Gender plan <input type="checkbox"/> Other actions/measures <input checked="" type="checkbox"/> No action/measure			
III. SOCIAL SAFEGUARD ISSUES AND OTHER SOCIAL RISKS			
Issue	Significant/Limited/ No Impact	Strategy to Address Issue	Plan or Other Measures Included in Design
Involuntary Resettlement	No impact		<input type="checkbox"/> Full Plan <input type="checkbox"/> Short Plan <input type="checkbox"/> Resettlement Framework <input checked="" type="checkbox"/> No Action

Issue	Significant/Limited/ No Impact	Strategy to Address Issue	Plan or Other Measures Included in Design
Indigenous Peoples	No impact		<input type="checkbox"/> Plan <input type="checkbox"/> Other Action <input type="checkbox"/> Indigenous Peoples Framework <input checked="" type="checkbox"/> No Action
Labor <input type="checkbox"/> Employment opportunities <input type="checkbox"/> Labor retrenchment <input type="checkbox"/> Core labor standards	Exim Bank will comply with national labor standards.		<input type="checkbox"/> Plan <input type="checkbox"/> Other Action <input checked="" type="checkbox"/> No Action
Affordability	No impact		<input type="checkbox"/> Action <input checked="" type="checkbox"/> No Action
Other Risks and/or Vulnerabilities <input type="checkbox"/> HIV/AIDS <input type="checkbox"/> Human trafficking <input type="checkbox"/> Others (conflict, political instability, etc), please specify	No impact		<input type="checkbox"/> Plan <input type="checkbox"/> Other Action <input checked="" type="checkbox"/> No Action
IV. MONITORING AND EVALUATION			
<p>Are social indicators included in the design and monitoring framework to facilitate monitoring of social development activities and/or social impacts during project implementation? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No</p> <p>This transaction does not require a design and monitoring framework.</p>			

MONITORING FRAMEWORK

Monitoring Area	Indicator	Fiscal Years				
		2006	2007	2008	2009	2010
A. Foreign Trade and Finance^a						
1. Direction of Trade – Diversification 2. and volume increase	<ul style="list-style-type: none"> • Asia and Pacific trade volume • South Asia trade volume • East Asia trade volume • Africa trade volume • Europe trade volume • America trade volume 					
3. Trade and Market Development (with data as may be available to Exim Bank)	<ul style="list-style-type: none"> • Increase in trade volume and value added • Number of new markets accessed (locations and products) • Total trade credit to total bank trade credit • Exim Bank share of trade credit 					
B. Exim Bank Performance						
4. Business Growth	<ul style="list-style-type: none"> • Loan growth over FY (outstanding) • South–south exposure to total loans outstanding • Asia exposure to total loans outstanding 					
5. Profitability	<ul style="list-style-type: none"> • Average annual net income growth • Return on average assets • Return on average equity • Cost–income ratio 					
6. Solvency	<ul style="list-style-type: none"> • Capital adequacy ratio (tier 1) • NPA in % of total loans • Of which rescheduled • Of which up to 180 days past due • Of which 181–365 days past due • Of which above 365 days past due 					
7. Market Development	<ul style="list-style-type: none"> • Exim Bank trade finance loans >5-year tenor (%) • Exim Bank trade finance loans <1 >5-year tenor (%) • Exim Bank loans for SME exports to <ul style="list-style-type: none"> • South Asia • East Asia and Pacific 					

Monitoring Area	Indicator	Fiscal Years				
		2006	2007	2008	2009	2010
	<ul style="list-style-type: none"> • Africa • Europe • North America • Proportion of lending to SME clusters and by India's states • And proportion of SME loans by region/continent 					
8. Credit Rating	<ul style="list-style-type: none"> • At par with Sovereign • Standard and Poor's • Fitch • Moody's 					

Exim Bank = Export-Import Bank of India, FY = fiscal year, SME = small and medium enterprise, NPA = nonperforming assets.

^a Based on Reserve Bank of India statistics.