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ASIA INSIGHT

India Economics

Asia Insight:
It's Time to Address the Fiscal Deficit Problem

Fiscal stimulus played a key role in the post crisis recovery, however, a persistent delay in reversing government spending and the resultant increase in inflation pressures is forcing the Central Bank to tighten monetary policy to control aggregate demand which is a sub optimal policy outcome. We believe fiscal consolidation will be necessary to returning to 8% plus growth path.

Key Debates

1) High growth post crisis – was it the result of good policy mix?

2) How does India compare with other EM's in its fiscal consolidation process since the crisis?

3) What is the medium-term solution to reduce the debt to GDP ratio?

4) What if the government does not reduce the fiscal deficit substantially?

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Summary

It's Time to Address The Fiscal Deficit Problem

Fiscal stimulus played a key role in post credit crisis recovery: The government's national fiscal deficit (central plus states combined) increased from 4.8% of GDP in F2008 to 10% in F2009. This expansionary fiscal policy has been a bigger growth driver than monetary easing over the past three years, in our view.

A large part of the increase since F2008 has been due to higher revenue expenditure: The government's expenditure increase was largely centered around the revenue items wages, subsidies and national rural wage scheme. Even the capital expenditure taken up by the government tends to generate low efficiency capital asset.

Low productive nature of government spending brought inflation pressures: This boost to consumption via public spending helped to offset the shortfall in growth from the decline in private investment to GDP. In other words, less productive public spending substituted the decline in productive private investment. Although this approach was justified for a short period immediately post credit crisis, the government pursued this approach for too long, which meant persistent inflation pressures and higher current account deficit.

Maintaining high fiscal deficit and pursuing monetary tightening is a sub-optimal policy outcome: Ideally, the response from the policymakers should have been a quick reversal in less productive government spending, cut in fiscal deficit to boost overall savings and at the same time initiate policy measures to boost private investments. However, a persistent delay in reversing government spending and the resultant increase in inflation pressures is forcing the Central Bank to tighten monetary policy to control aggregate demand which is only adversely affecting the growth in private investment and taking non-accelerating inflationary growth potential lower.

Summary

F2012 Fiscal Deficit will likely be significantly higher than budgeted: We expect central government fiscal deficit to overshoot to about 6% of GDP in F2012 vs. budget estimate of 4.6% of GDP. We expect consolidated fiscal deficit (including states deficit) to be at 8.3% of GDP. Moreover, if we include off-budget expenditure, we estimate the national consolidated fiscal deficit will be 9.2% of GDP in F2012 (YE March 2012). Indeed, in 2011 we expect India to run the largest fiscal deficit among key emerging markets.

While many other AXJ countries resorted to fiscal stimulus post credit, India has reversed it the least: Overall fiscal deficit in India (including off-budget expenditure) increased from 4.8% of GDP in F2008 to 10% of GDP in F2009 and is expected to be at 9.2% of GDP in F2012 (YE March 2012). In AXJ ex India fiscal balance to GDP worsened from 0.8% of GDP in 2007 to -2.7% of GDP in 2009, however with the reversal in fiscal stimulus, fiscal balance to GDP is expected to improve to -1.9% in 2011.

What is the medium-term solution? To reduce the debt-to-GDP ratio, we believe that the government needs to address the primary deficit (consolidated), which stood at 4.5% of GDP in F2012, as per our estimates. The primary deficit is total receipts less non-interest expense or in other words the fiscal deficit less interest payments.

Fiscal consolidation is the key to returning to a higher growth path: Fiscal consolidation will be necessary for returning to 8% plus GDP growth. We believe that a heavy fiscal deficit burden is one of the major hurdles to the government achieving its GDP growth target of 8% plus on a sustainable basis. A sustainable reduction in the government's deficit would likely have to entail difficult and sensitive measures, in our view.

What if the government does not reduce the fiscal deficit substantially? Clearly, an expansionary fiscal policy was supporting India's growth until recently – seemingly without any major concomitant costs. The costs of this policy will be evident in the form of higher real interest rates, lower resources for productive expenditure and slower growth, and these costs will be magnified if global capital inflows were to slow down, in our view.

Understanding India's Fiscal Deficit Structure

Structure of India's Fiscal Deficit (F2012E)

On – Budget Deficit

Central Government Tax Revenue — US$ 125bn, 6.7% of GDP

Less

Central Government Non Tax Revenue — US$ 26bn, 1.4% of GDP

Less

Central Government Expenditure — US$ 269bn, 14.4% of GDP

Equals

Central Government Deficit — US$ 111bn, 6% of GDP

Add

State Deficit — US$ 43bn, 2.3% of GDP

Equals

Consolidated Fiscal Deficit = 8.3% of GDP

Add

Off – Budget Deficit

Off – Budget Oil Subsidy — US$ 8bn, 0.4% of GDP

Add

Off – Budget Food Subsidy — US$ 3bn, 0.2% of GDP

Add

Off – Budget Fertilizer Subsidy — US$ 6bn, 0.3% of GDP

Equals

Total Off – Budget Subsidy — US$ 17bn, 0.9% of GDP

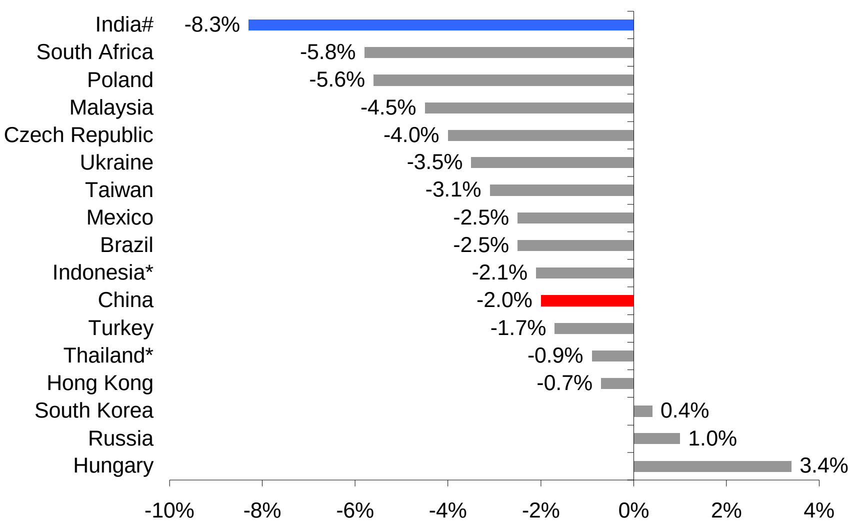
Equals

Consolidated Fiscal Deficit (Including off budget items) = 9.2% of GDP

Source: Budget Documents, E=Morgan Stanley Research Estimates
**USD/INR at average of 48.6 for F2012*

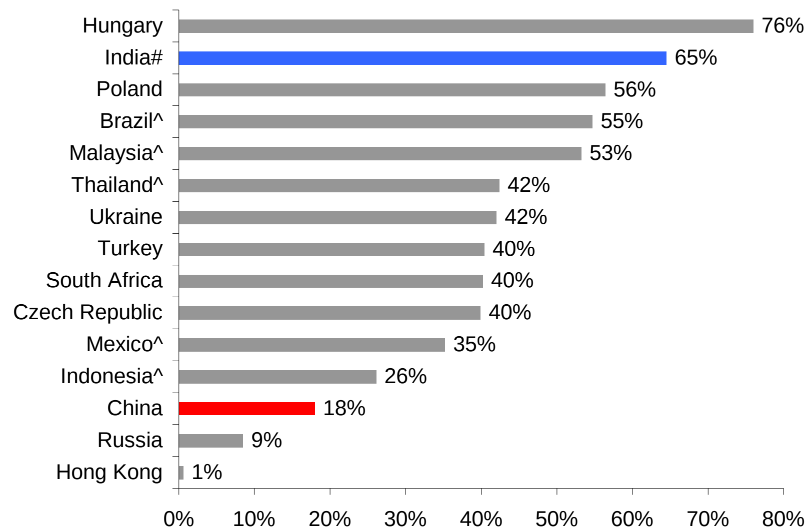
India Runs the Highest Fiscal Deficit Among Major Emerging Markets

Select Emerging Markets: Budget Balance (As % of GDP, 2011E)



Source: CEIC, Haver, Morgan Stanley Research, E=Morgan Stanley Research Estimates
**2010, # refers to F2012E (excluding off-budget expenditure)*

Select Emerging Markets: Public Debt (As % of GDP, 2011E)



Source: CEIC, Haver, Morgan Stanley Research, E=Morgan Stanley Research Estimates
^2010, # refers to F2012E

In 2011, we expect India to run the largest fiscal deficit among key emerging markets: After having pushed fiscal deficit post credit crisis, India has been very slow in reversing its expansionary fiscal policy. Indeed, if we include off-budget expenditure, we estimate the national consolidated fiscal deficit will be 9.2% of GDP in F2012 (YE March 2012) compared with headline excluding off-budget at 8.3% of GDP.

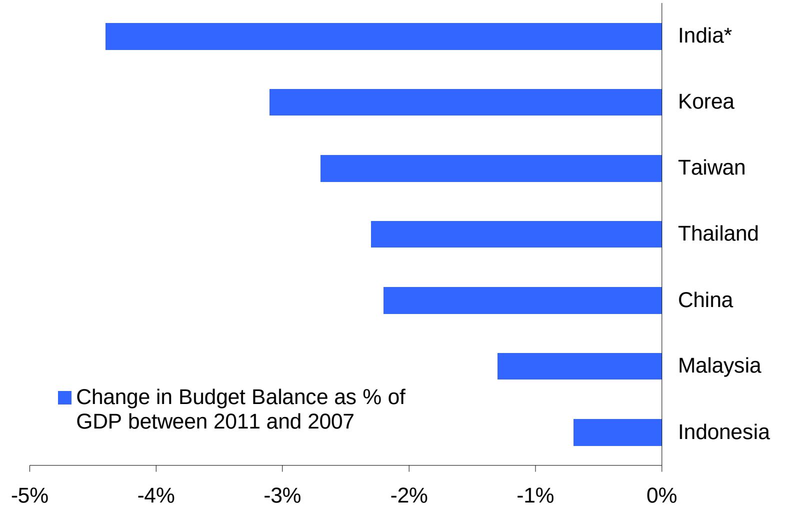
No Improvement in India’s Fiscal Performance Since the Crisis

AXJ: Budget Balance as % of GDP

Budget Balance (as a % of GDP)					
	2007	2008	2009	2010	2011E
India*	**-4.8%**	**-10.0%**	**-9.8%**	**-7.8%**	**-9.2%**
Hong Kong	7.5%	0.1%	1.6%	4.2%	-0.7%
Singapore	2.4%	-0.8%	-1.0%	-0.1%	0.0%
Thailand	-0.4%	-1.3%	-3.5%	-0.9%	-2.7%
Taiwan	-0.4%	-0.9%	-4.5%	-3.3%	-3.1%
China	0.2%	-0.8%	-2.8%	-2.5%	-2.0%
Indonesia	-1.3%	-0.1%	-1.6%	-2.1%	-2.0%
Korea	3.5%	1.2%	-1.7%	-0.2%	0.4%
Malaysia	-3.2%	-4.8%	-7.0%	-5.6%	-4.5%

Source: CEIC, Haver, Morgan Stanley Research, E=Morgan Stanley Research Estimates
** Refers to FY basis for India*

AXJ: Change in Budget Balance as % of GDP Since Crisis



Source: CEIC, Haver, Morgan Stanley Research, E=Morgan Stanley Research Estimates
**Refers to FY basis for India*

While many other AXJ countries resorted to fiscal stimulus post credit crisis, India has reversed it the least: In AXJ ex India, fiscal balance to GDP worsened from 0.8% of GDP in 2007 to -2.7% of GDP in 2009, however with the reversal in fiscal stimulus, fiscal balance to GDP is expected to improve to -1.9% in 2011.

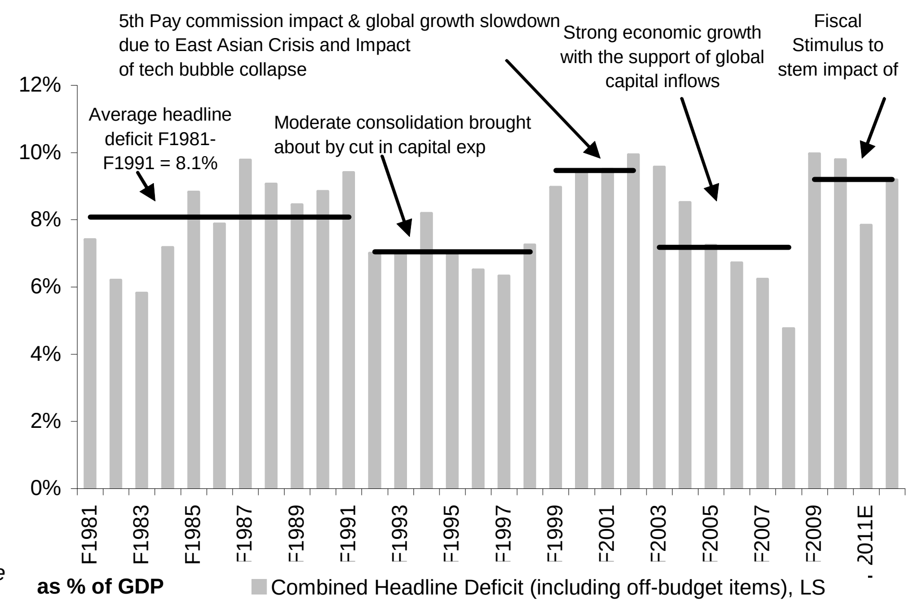
Fiscal Deficit has Remained High Post Crisis

India's Consolidated Fiscal Deficit

As % of GDP	F2008	F2009	F2010	F2011E	F2012E
Central Fiscal Deficit	2.5%	6.0%	6.4%	4.7%	6.0%
State Fiscal Deficit	1.5%	2.4%	3.3%	2.5%	2.3%
Sub-total	**4.1%**	**8.4%**	**9.7%**	**7.2%**	**8.3%**
Inter-government adjustments	-0.1%	-0.1%	-0.1%	0.0%	0.0%
Combined Headline Deficit	**4.0%**	**8.3%**	**9.6%**	**7.2%**	**8.3%**
Major Off-budget expenditure items	0.8%	1.6%	0.2%	0.6%	0.9%
Overall Fiscal Deficit	**4.8%**	**10.0%**	**9.8%**	**7.8%**	**9.2%**
Overall Fiscal Deficit (excluding 3G receipts)	*NA*	*NA*	*NA*	*9.2%*	*9.4%*

*Note: *Here the off-budget items include expenditure on oil, food and fertilizer. We have assumed oil prices average US$110/bbl in F2012.*
E = Morgan Stanley Research estimates.
Source: RBI, Economic Survey, Ministry of Finance, Morgan Stanley Research

Tracking Poor Fiscal Record

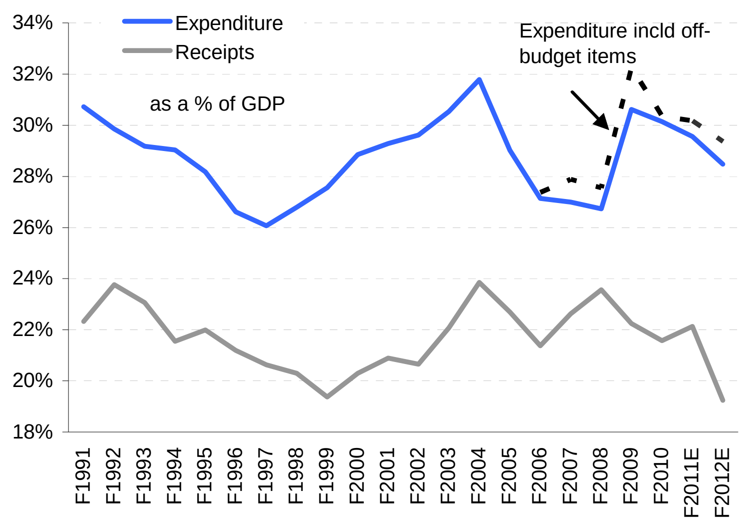


Source: Budget Documents, RBI, Morgan Stanley Research

Consolidated national fiscal deficit has been in the range of 9-10% of GDP for the fourth year running: Post credit crisis, the government pushed growth through increased fiscal spending, which primarily took the form of fiscal transfers to the poor. The stimulus led to an increase in total government spending (centre + state) by 4% pts of GDP between F2008 and F2009.

Reconciling – What Components Drove up the Deficit?

Mind the Gap: National Expenditure vs. Receipts



Reconciling Increase in Fiscal Deficit between F2008 and F2009

As % of GDP	F2008	F2009	Pct Change: F2009 and 2008
Central Governmnet Fiscal Balance			
Revenue Receipts	**10.9%**	**9.7%**	**-1.2%**
--Tax Revenue	8.8%	7.9%	-0.9%
--Non Tax Revenue	2.1%	1.7%	-0.3%
Capital Receipts (ex-borrowings)	**0.2%**	**0.1%**	**-0.1%**
Expenditure	**13.6%**	**15.8%**	**2.2%**
--Revenue Expenditure	11.9%	14.2%	2.3%
---*Wages, Salaries & Pensions*	*1.5%*	*2.0%*	*0.5%*
---*Subsidy*	*1.4%*	*2.2%*	*0.9%*
---*MGNREGS*	*0.3%*	*0.6%*	*0.3%*
Fiscal Deficit (Centre)	**2.5%**	**6.0%**	**3.5%**
State Government Fiscal Balance			
State Total Receipts	12.6%	12.4%	-0.2%
State Total Expenditure	14.2%	14.9%	0.7%
State Fiscal Defciit	**1.5%**	**2.4%**	**0.9%**
Consolidated Fiscal Deficit	**4.0%**	**8.3%**	**4.4%**
Off-Budget Items	*0.8%*	*1.6%*	*0.8%*
Overall Consolidated Deficit (incld off budget items)	***4.8%***	***10.0%***	***5.2%***

- **A large part of the increase in deficit in F2009 and F2010 has been due to higher revenue expenditure**: The government's expenditure increase was largely centered around the revenue items wages, subsidies and national rural wage scheme.
- **In F2012, the slowdown in growth and tax revenues will likely keep the deficit high**: Although government expenditure growth has begun to slow, tax revenues are decelerating even faster keeping fiscal deficit in the range of 9-10%.

Source: RBI, Budget Documents, Morgan Stanley Research

F2012 Deficit Will Likely be Significantly Higher than Budgeted

Government is likely to miss the F2012 budget estimates for deficit by a big margin: Last year the government was able to reduce national (w/o off-budget items) and central fiscal deficit to 7.2% and 4.7% of GDP respectively, on account of the revenue from 3G license fees equivalent to 1.35% of GDP. However, this year the government is facing several receipt gaps. We expect central government fiscal deficit to overshoot to about 6% of GDP in F2012 vs. budget estimate of 4.6% of GDP. We expect consolidated fiscal deficit (including states deficit) to be at 8.3% of GDP. Moreover, if we include off-budget expenditure, national consolidated fiscal deficit would be 9.2% of GDP in F2012 (YE March 2012), on our estimates.

First, there is no one-off revenue from sources such as 3G license fees – Last fiscal, the government was able to consolidate fiscal deficit on account of the one-off revenue receipts from auction of 3G license which amounted to 1.35% of GDP.

Second, loss in revenue on account of cut in custom and excise duty on petroleum products – The government cut excise and custom duty on petroleum products in June this year, which will result in a loss of revenue of 0.5% of GDP.

Third, the ensuing growth slowdown is beginning to weigh on tax collections – Excise and customs duty growth has already slipped below budget estimates. Indeed for Sep-Oct average custom and excise duty growth was at 0.1% and -5%, respectively. Further corporate tax growth has also slowed to 7% in Sep-Oct vs. target growth of 20% for F2012.

Fourth, the government is finding it difficult to initiate the divestment program as planned in the budget - Given the volatile capital market environment, divestment proceeds are only at INR 27.3bn currently vs. BE of INR 400bn.

F2012 Deficit Will Likely be Significantly Higher than Budgeted

Consolidated Fiscal Deficit: F2012E (As % of GDP)

	YoY%		As % of GDP		
	F2012BE	F2012MSe	F2011	F2012BE	F2012MSe
I. Revenue Receipts	**-1.0%**	**-8.0%**	**10.1%**	**8.7%**	**8.1%**
(a) Tax Revenue	**16.0%**	**6.0%**	**7.3%**	**7.3%**	**6.7%**
-- Gross tax revenue	**18.5%**	**8.6%**	**10.0%**	**10.3%**	**9.4%**
Indirect Taxes					
-- Customs	11.0%	7.0%	1.7%	1.7%	1.6%
-- Excise	19.0%	5.0%	1.8%	1.8%	1.6%
-- Service Tax	15.0%	26.0%	0.9%	0.9%	1.0%
Direct Tax					
-- Corporation tax	20.0%	3.0%	3.8%	4.0%	3.4%
-- Personal Income tax	24.0%	18.0%	1.8%	1.9%	1.8%
(b) Non-tax Revenue	**-43.0%**	**-43.0%**	**2.8%**	**1.4%**	**1.4%**
II. Capital Receipts (ex-borrowings)	**55.0%**	**-16.0%**	**0.5%**	**0.6%**	**0.3%**
--Recoveries of Loans	18.0%	18.0%	0.2%	0.2%	0.2%
--Divestment	75.0%	-34.0%	0.3%	0.4%	0.2%
III. Total Expenditure	**4.9%**	**8.9%**	**15.2%**	**13.8%**	**14.4%**
IV.Centre's Fiscal Deficit	**-**	**-**	**4.7%**	**4.6%**	**6.0%**
V. State Fiscal Deficit*	-	**-**	**2.5%**		**2.3%**
VI. Off-Budget Subsidy Items	-	**-**	**0.6%**		**0.9%**
Consolidated Fiscal Deficit	-	**-**	**7.8%**		**9.2%**

We are assuming lower growth in excise and customs due to reduction in excise & custom duty on gasoline products and also the recent slowdown in economic activity. Indeed Sep-Oct excise and custom duty growth has averaged -5% and 0.1%, respectively. In the case of a 5%pt reduction each in custom and excise duty growth, we estimate fiscal deficit to GDP to increase by approx 5bps each.

We are assuming slower growth in corporation tax, based on the on-going moderation in economic activity. Indeed corporation tax growth has only averaged 7.4% in Sep-Oct. A 5%pt reduction in growth would increase fiscal deficit to GDP by approx 10bps.

We are assuming divestment proceeds of INR 150bn in F2012 vs. BE of INR 400bn (and INR 27bn until Oct11). In the case of divestments remaining at INR 11bn fiscal deficit to GDP would increase by approx 15bps.

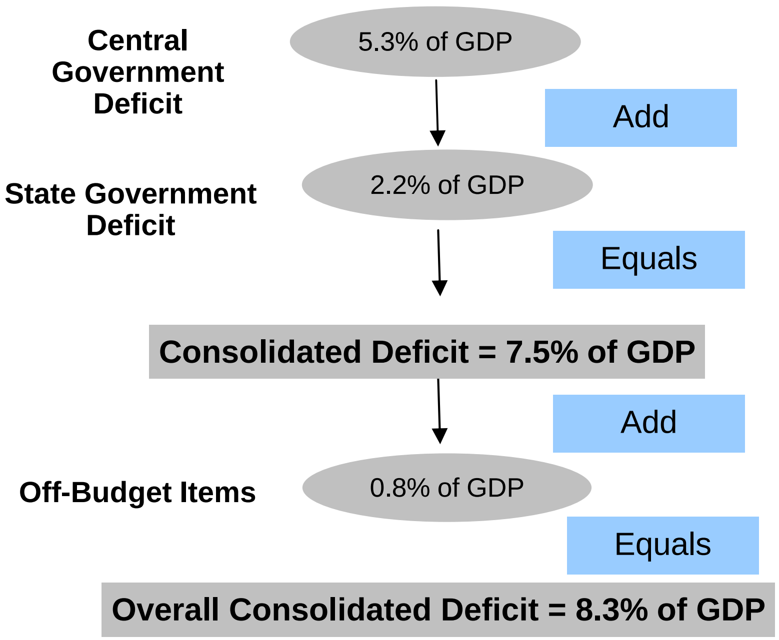
Assuming total expenditure growth at 8.9% for F2012 vs. FYTD growth of 10.2%. In the case of a 1%pt increase in growth fiscal deficit to GDP would increase by approx 10-12bps.

If the worst case scenario were to emerge for the above key sensitive line items, fiscal deficit could be higher at 6.3-6.5% in F2012

Source: RBI, Morgan Stanley Research E=Morgan Stanley Research Estimates

F2013 Fiscal Deficit to Remain High

Consolidated Fiscal Deficit: F2013E (As % of GDP)



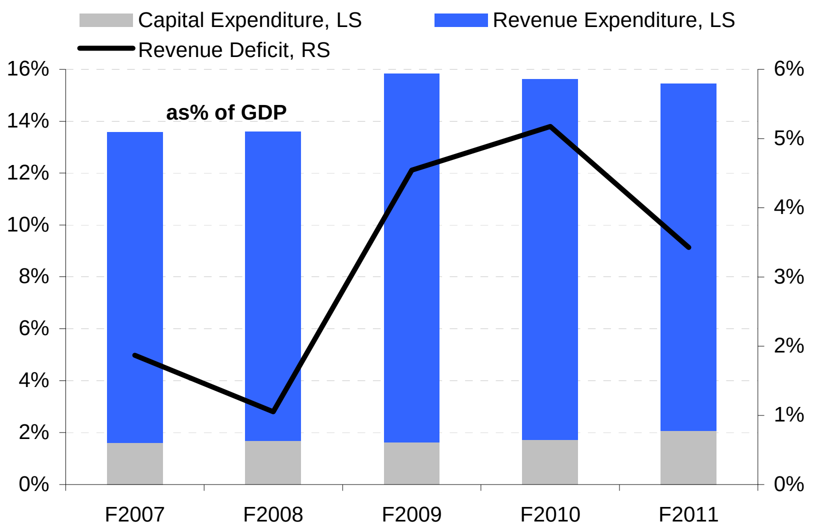
Factors that can reduce the deficit from our Estimate	Factors that can increase the deficit from our Estimate
Lower global crude prices or de-regulation of administered fuel prices will reduce subsidy burden - we are currently assuming about 0.5% of GDP as off-budget oil subsidy	Higher crude oil prices -- leading to further increase in oil subsidy. A US$10/bbl change in oil prices increases subsidy by 0.3% of GDP
Higher divestment proceeds. We are currently assuming divestment proceeds of approx 0.3% of GDP.	Lower divestment proceeds
One time excess spectrum charge of US$3.37bn or 0.2% of GDP	Higher food subsidy -- We are assuming 1% of GDP currently. However the form of implementation of the food security bill could increase deficit by 0.3-0.4% pt of GDP
Possibility of coal bloc auctions (US$1.5-3bn / 0.1-0.2% of GDP)	

Fiscal deficit to remain high in F2013 as well: We expect economic activity growth to remain slow, thus providing no upside surprise on revenue front. Along with it, higher subsidy incurred in the form of food security will add to pressures on the expenditure front. We are assuming the government increases tax rates for services and excise duty in Feb 2012.

Source: RBI, Morgan Stanley Research E=Morgan Stanley Research Estimate

Low Productivity Nature of Government Spending

Central Government Expenditure: Biased towards Revenue Spending



Source: RBI, Morgan Stanley Research, Excluding Off – Budget Expenditure

Central Government Expenditure: Low Productivity Nature of Government Spending

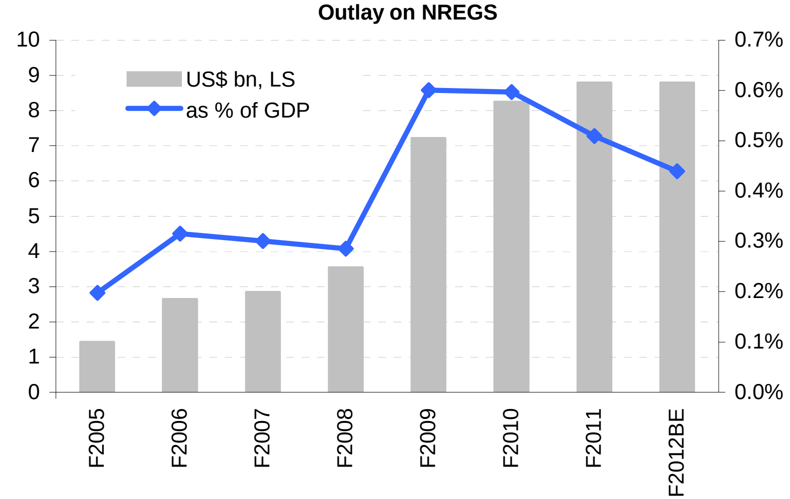
	F2008	F2009	F2010	F2011
	as % of GDP			
Revenue Expenditure	**11.9%**	**14.2%**	**13.9%**	**13.4%**
-Subsidy	1.4%	2.2%	2.1%	2.0%
---Food	*0.6%*	*0.8%*	*0.9%*	*0.8%*
---Fertilizer	*0.7%*	*1.4%*	*0.9%*	*0.7%*
---Petroleum	*0.1%*	*0.1%*	*0.2%*	*0.5%*
-Interest Payments	3.4%	3.4%	3.3%	3.1%
-Defense	1.8%	2.0%	2.2%	1.9%
Capital Expenditure	**2.4%**	**1.6%**	**1.7%**	**2.1%**
Total Expenditure	***13.6%***	***15.8%***	***15.6%***	***15.4%***
Off-Budget Subsidy	*0.8%*	*1.6%*	*0.2%*	*0.6%*
Total Expenditure (incld Off-budget items)	14.4%	17.5%	15.9%	16.1%

Source: Budget Documents, RBI, Morgan Stanley Research

Bias to spend more on revenue account: The government's spending has traditionally been more biased towards revenue expenditure. Even the capital expenditure taken up by the government tends to generate low efficiency capital asset.

Low Productivity Nature of Government Spending

Spending On National Rural Employment Guarantee Act (NREGA) Scheme



Source: Budget Documents, Morgan Stanley Research

Large Proportion of NREGA Spending is on Wages

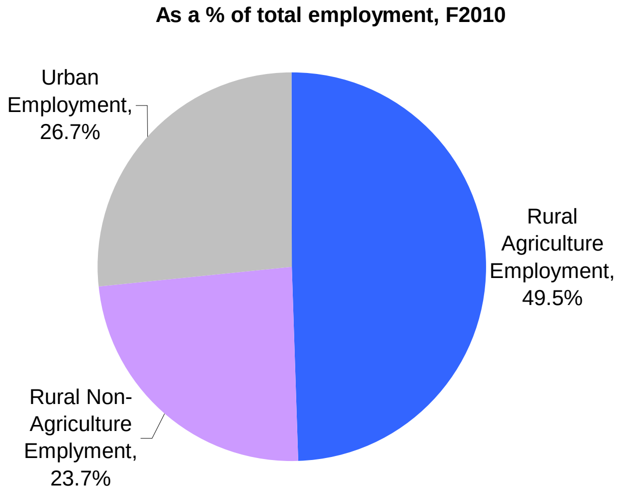
	% Expenditure on Wages	% Expenditure on Materials
F2009	68.4%	31.6%
F2010	69.8%	30.2%
F2011	69.2%	30.8%
F2012*	72.8%	27.2%

*Source: MGNREGS, Morgan Stanley Research * - Data for Apr - Nov*

Unproductive dynamics of the NREGA have boosted rural wages but without a significant improvement in rural productivity: Although this program had the right policy intentions, its implementation has caused distortions in the economy, in our view. This program has had an adverse impact on domestic inflation for three reasons: (a) it discouraged workers to go to farms; (b) local governments that did not have the administrative setup to run this program ended up transferring payouts to workers without getting the full productive utilization of the workers' time; and (c) those receiving these transfers ended up spending more on food, since this represents a large proportion of their consumption basket. Labour Bureau statistics indicate that agricultural wages in India have risen by a cumulative 105% in the last three years.

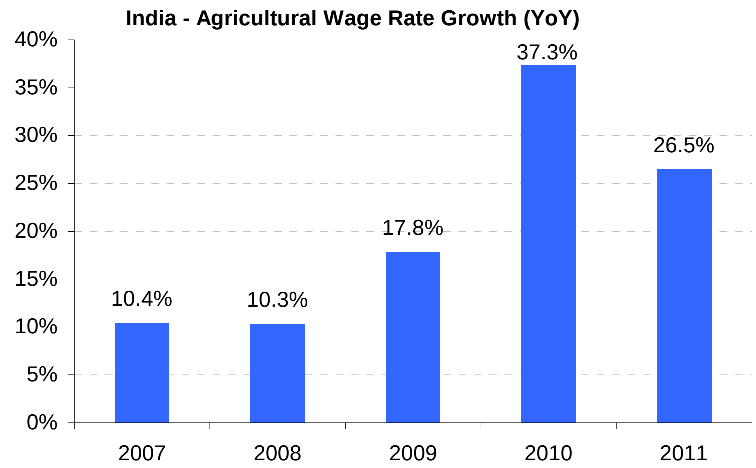
Low Productivity Nature of Government Spending

Rural Workforce Accounts For 73% of Total



Source: NSSO, Morgan Stanley Research

Rural Wages Have Spiked Up

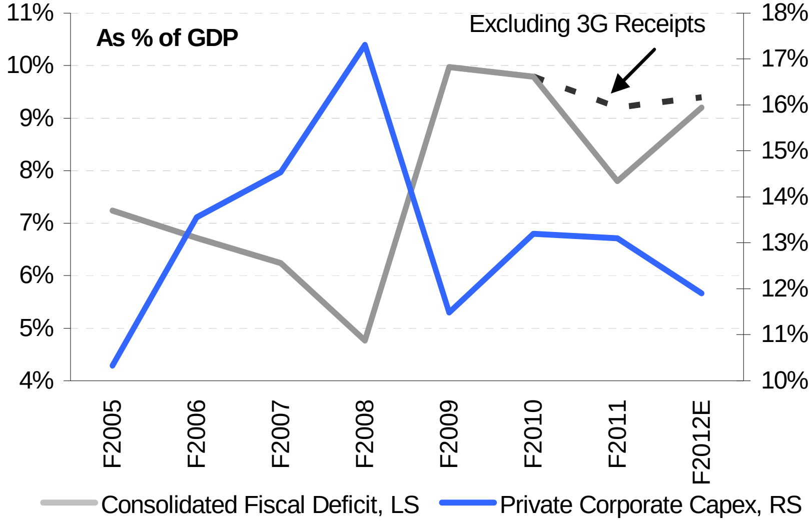


Source: Labour Bureau, Morgan Stanley Research
Agricultural Wages are as of July for each year expect 2009 is as of June

NREGA has caused cost push inflation with intervention in rural labour market: The NREGA has had a far-reaching impact on rural wages, disturbing the dynamics of the labour market. It is indeed odd, that a country like India, with such a strong demographic trend, has ended up pushing wages in a rather less productive manner. In our view, NREGA is one of the key factors pushing food prices higher and fueling inflation expectations. The transfer of income to poor households through the NREGA and other fiscal measures has increased the demand for food at a time when the government has done little to improve the supply of farm output. Moreover, this policy-led push to rural wages happened at a time when urban labour productivity had been affected by a sharp slowdown in private corporate investment. Not surprisingly, primary food price levels have increased by about 65% since January 2008

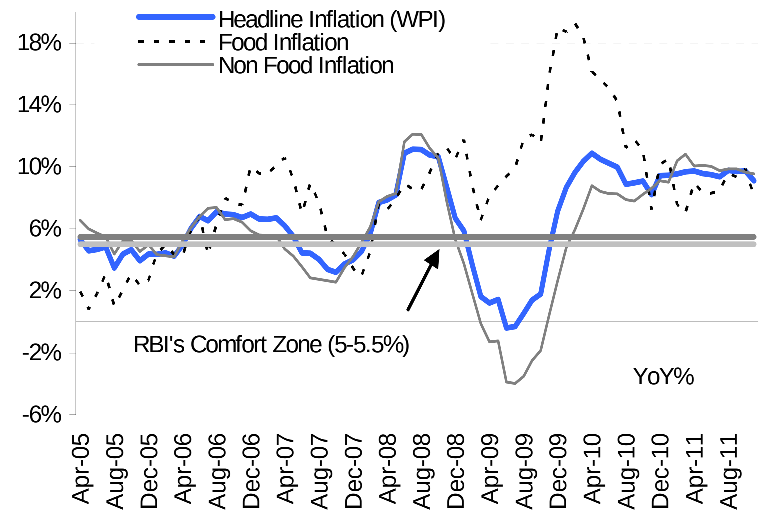
Bad Mix of Growth for Four Years Running

Fiscal Deficit Vs. Pvt Corporate Capex (as % of GDP)



Source: Budget Documents, Morgan Stanley Research, E=Morgan Stanley Research Estimates

Inflation (WPI): Above RBI's Comfort Zone for Past 24 Months

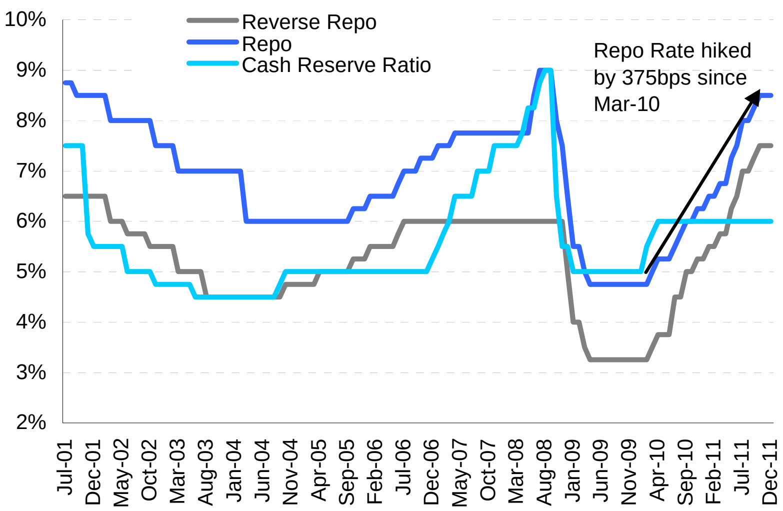


Source: CEIC, Morgan Stanley Research

Boost to consumption (via high deficit) but slower growth in productive capacity meant persistent inflation pressures: The government's national fiscal deficit (central plus states combined) increased from 4.8% of GDP in F2008 to 10% in F2009. This expansionary fiscal policy has been a bigger growth driver than monetary easing over the past three years, in our view. This boost to consumption via public spending helped to offset the shortfall in growth from the decline in private investment to GDP. In other words, less productive public spending substituted the decline in productive private investment. Although this approach was justified for a short period immediately post credit crisis, the government pursued this approach for too long, which meant persistent inflation pressures.

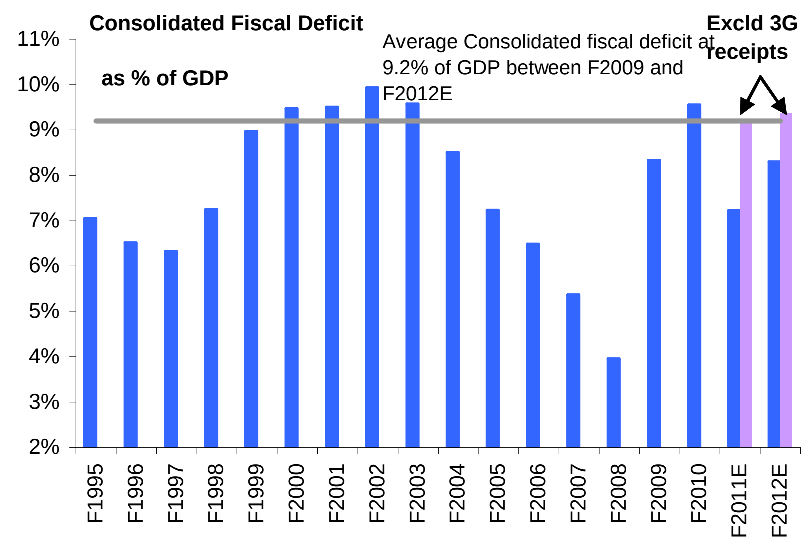
Burden of Inflation Management Has Been Solely on Monetary Policy: A Sub-Optimal Policy Mix

Policy Rates Tightened to Fight Inflation



Source: RBI, Morgan Stanley Research

Lack of Fiscal Consolidation Since the Onset of Crisis



Source: Budget Documents, Morgan Stanley Research
E=Morgan Stanley Research Estimates

Maintaining high deficit and pursuing monetary tightening to rein in aggregate demand is a sub-optimal policy outcome: Ideally, the response from the policymakers should have been a quick reversal in less productive government spending, cut in fiscal deficit to boost overall savings and at the same time initiate policy measures to boost private investments. However, a persistent delay in reversing government spending and the resultant increase in inflation pressures is forcing the Central Bank to tighten monetary policy to control aggregate demand which is only adversely affecting the growth in private investment and taking non-accelerating inflationary growth potential lower.

How Does Government Fund It?

Central Plus State Government Deficit Funding

	Financing of Centre's Gross Fiscal Deficit			
	F2011RE	F2012BE	F2011RE	F2012BE
	INR bn		% of Total	
External finance	223	145	5.9%	3.6%
Mkt Borrowings	3355	3531	**88.6%**	**88.7%**
Other borrowings	582	252	15.4%	6.3%
Draw down of Cash Balances	-150	200	-4.0%	5.0%
Total	3787	3983	100.0%	100.0%

	Financing of State's Gross Fiscal Deficit			
	F2010RE	F2011BE	F2010RE	F2011BE
	INR bn		% of Total	
Loans from Cen Govt	49	70	2.2%	3.5%
Mkt Borrowings	1234	1326	57.1%	66.8%
Special Securities Issued to NSSF	190	121	8.8%	6.1%
State Provident Fund, Small Savings, etc.	657	469	30.4%	23.6%
State Fiscal Defciit	2161	1985	100.0%	100.0%

Source: RBI, Morgan Stanley Research

Ownership of Centre Plus State Government Securities

	Central and State Government securities - Outstanding as on			
	Mar-09	Mar-10	Mar-09	Mar-10
	INR bn		as % of total	
Total	**19595**	**23512**	**100%**	**100%**
Reserve Bank of India	**1651**	**2381**	**8%**	**10%**
Scheduled Commercial Banks	**11759**	**13900**	**60%**	**59%**
--SBI & associates	3076	3182	16%	14%
--Nationalised Banks	5223	6851	27%	29%
--Other Scheduled Commercial Banks	3197	3506	16%	15%
--Regional Rural Banks	263	361	1%	2%
Primary Dealers	**32**	**30**	**0.2%**	**0.1%**
Insurance Companies	**4114**	**4881**	**21%**	**21%**
Financial Institutions	**310**	**554**	**2%**	**2%**
Mutual Funds	**122**	**54**	**1%**	**0%**
Provident Funds	**940**	**1151**	**5%**	**5%**
Others	**667**	**560**	**3%**	**2%**

Source: RBI, Morgan Stanley Research

Government is primarily dependent on banks, insurance companies, provident funds and household saving schemes: Traditionally, banks and insurance have funded the bulk of the government's borrowing program. In F2012, we believe the overall deficit funding requirement for the central government will be INR 5.4trillion (including market borrowing), similarly the state government's overall borrowing requirement will be INR 2.1 trillion.

How Has India Managed Relatively High Fiscal Deficit So Far?

Internal debt less external debt: First, and probably the most important factor that helps India manage this high level of public debt, is the fact that India's deficit has been funded largely through domestic debt as opposed to external debt. In fact, the ratio of external public debt to India's total public debt in the past 10 years has averaged at about 10.2% compared to 60% for all emerging markets.

Limited capital account convertibility: The Reserve Bank of India (RBI) has been careful in liberalizing the capital account for residents. Over the years, RBI has reduced the capital account restrictions for companies. However, there are still significant restrictions for individuals. Household savings remain captive for the government to fund its deficit.

Mandatory purchase of government debt by banks: Banks are required to invest 24% of their total net demand and time liabilities (NDTL) in government approved securities. This ensures a captive demand for government paper.

Capital inflows ensure the private sector does not suffer from crowding out: Typically, the cost of a high fiscal deficit would have been higher real interest rates. However, India has witnessed an unusually low real interest rate environment right at the time when its fiscal policy has been expansionary as reflected in rising public debt to GDP. The key to lower-than warranted real interest rates is the supply of global liquidity in the form of portfolio and debt inflows. About 74% of the total US$272 billion capital flows that India has received over the past five years have been in the form of non-FDI flows.

If global capital markets remain weak for longer, risk of crowding out will rise: We believe that if the ongoing deleveraging results in weaker global capital markets and therefore lower capital inflows into India, persistent high fiscal deficit will increase the real interest rates for the domestic private sector.

Fiscal Consolidation is the Key for Returning to a Higher Growth Path?

Fiscal consolidation will be necessary for returning to 8% plus GDP growth: We believe that a heavy fiscal deficit burden is one of the major hurdles to the government achieving its GDP growth target of 8% plus on a sustainable basis. A sustainable reduction in the government's deficit would likely have to entail difficult and sensitive measures, in our view

First, the government needs to cut non-interest revenue expenditure. If we compare with other countries in the region, India's tax to GDP ratio is one of the highest. The main reason for the high level of fiscal deficit appears to be higher expenditure. The government could initiate major expenditure reforms and move effectively to outcome-based expenditure management from the current outlay-based system to cut non-interest revenue expenditure. Over the past four years, there has been little control on non-development expenditure, which has been one of the key factors for the rise in total expenditure to 29.6% of GDP in F2011 from 27.1% of GDP in F2006. Indeed, including off-budget expenditure, total expenditure increased to 30.2% of GDP in F2010. In the same period, total receipts to GDP has increased by only 0.7% of GDP. Hence, we believe the key to better fiscal management will be to cut expenditure to GDP gradually over the next few years.

Second, interest costs currently form about one-fourth of total receipts and one-fifth of total expenditure. Indeed, interest costs have been consistently higher than capital expenditure since the mid-1990s. To control the interest cost component, India needs not only to stop accruing fresh debt for funding less efficient current consumption expenditure but also to reduce its stock of debt to GDP.

Third, accelerate privatization of public sector companies to reduce the debt burden ratio in a short period. Currently, the government is also suffering from a high debt service burden arising from past debt. While the public debt to GDP has been high, the good news is that the government's assets have also increased significantly over the past few years. We estimate that the total value of listed government owned companies at about US$200 billion currently. This does not include value of unlisted government owned companies in about 238 companies, which could be significant as well.

Appendix

Appendix: Sovereign Credit Rating

India: Foreign Currency Debt Ratings

S&P	Moody's	Fitch
BBB+	Baa1	BBB+
BBB	Baa2	BBB
BBB-	**Baa3**	**BBB-**
BB+	Ba1	BB+
BB	Ba2	BB
BB-	Ba3	BB-
B+	B1	B+
B	B2	B
B-	B3	B-

Cut off for investment grade

India: Local Currency Debt Ratings

S&P	Moody's	Fitch
BBB+	Baa1	BBB+
BBB	Baa2	BBB
BBB-	**Baa3**	**BBB-**
BB+	Ba1	BB+
BB	Ba2	BB
BB-	Ba3	BB-
B+	B1	B+
B	B2	B
B-	B3	B-

Rating agency view in the last rating update in 2011: **S&P** in the rating outlook note on Nov 2011, maintained the sovereign credit ratings with stable outlook. It highlighted good growth prospects, moderately deep capital markets and adequate external liquidity as the positive factors and cautioned for the weakness from fiscal inflexibility from high debt and large fiscal deficit and high inflation.

Fitch in the rating outlook in June 2011 maintained the sovereign credit ratings with a stable outlook. It noted the strengths to be economic growth, modest external debt service ratio and high level of FX reserves while it highlighted the public finances as a key weakness.

Moody's in an update in Dec 2011 increased the local currency debt rating to Baa3 (investment grade) from Ba1 earlier. Moody's had upgraded India's foreign currency debt rating to investment grade in 2004. It highlighted the need to have a divergence in foreign and local currency debt rating only in very compelling cases. It highlighted the strengths to be – robust medium term growth prospects, diversified economic structure, high domestic savings rate helping to finance government debt. It noted the challenges to be: weak government finance, policy process slowed by politics, susceptibility to inflationary pressures, and constraints of poor physical and social infrastructure on future growth.

Appendix: Sovereign Credit Rating

India Macro Balance Sheet

	F2001	F2005	F2006	F2007	F2008	F2009	F2010	F2011	F2012E
Real GDP Growth (YoY%)	4.4%	7.5%	9.5%	9.6%	9.3%	6.8%	8.0%	8.3%	7.0%
WPI (YoY avg)	7.1%	6.5%	4.4%	6.5%	4.8%	8.1%	3.9%	9.6%	8.9%
FX Reserves (US$ bn)	42.3	141.5	151.6	199.2	309.7	252.0	279.1	301.1	312.0
Import Cover (No of months)	8.8	14.3	11.6	12.5	14.4	9.8	11.1	9.5	7.5
Current Account Deficit as % of GDP	(0.6%)	(0.3%)	(1.2%)	(1.0%)	(1.3%)	(2.3%)	(2.8%)	(2.6%)	(2.6%)
Short term Debts as % of FX Reserves	8.6%	12.5%	12.9%	14.1%	14.8%	17.2%	18.8%	21.6%	22.8%
External debt as % of GDP	22.1%	17.1%	16.6%	18.2%	18.1%	18.7%	18.9%	17.7%	17.8%
Consolidated Deficit (Centre + State) as % of GDP	9.5%	7.2%	6.5%	5.4%	4.0%	8.3%	9.6%	7.2%	8.3%
Public Debt as % of GDP	70.6%	79.1%	77.4%	74.1%	71.4%	72.1%	69.1%	64.9%	64.5%
External Debt Service Ratio	16.6	5.9	10.1	4.7	4.8	4.4	5.5	4.2	

Moody's upgraded Foreign Currency debt rating in 2004 to investment grade

Fitch upgraded Foreign Currency debt rating in 2006 to investment grade

S&P upgraded Foreign Currency debt rating in 2007 to investment grade

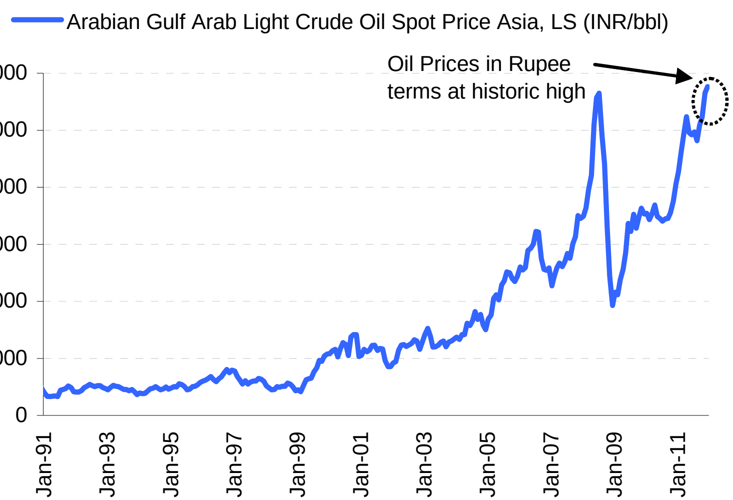
Moody upgraded Local currency debt rating in Dec 2011 to investment grade. S&P and Fitch had upgraded local currency debt rating to investment grade in 2007 & 2006 respectively

No immediate risk of a downgrade in ratings: Considering the current healthy FX reserves (US$304bn), moderate external and public debt to GDP (17.7% and 65%, respectively) and external debt-service ratio (at 4.2) , we do not see an immediate risk of a downgrade in ratings.

Source: CEIC, Morgan Stanley Research E=Morgan Stanley Research Estimate

Appendix: Off – Budget Oil Subsidy

Oil Price in INR Terms at Historical High



Source: Bloomberg, Morgan Stanley Research

High Oil Prices Putting Pressure on Off-Budget Oil Subsidy

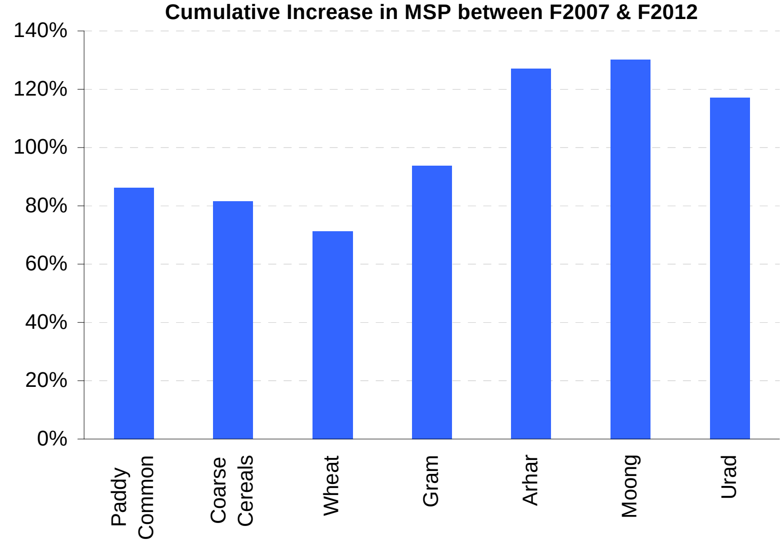
	F2009	F2010	F2011	F2012MSe
Crude Prices (Arab Light, US$/bbl)	US$ 83	US$ 70	US$ 85	US$ 110
Total Subsidy, Rs bn	**1,033**	**461**	**780**	**1,238**
Total Subsidy (As % of GDP)	1.9%	0.7%	1.0%	1.4%
- Government of India, Rs bn	**713**	**260**	**390**	**619**
(Direct Subsidy and Oil Bonds)	*69%*	*56%*	*50%*	*50%*
- Oil Companies, Rs bn	**320**	**201**	**390**	**619**
-- Downstream players & refiners	0	56	130	206
-- Upstream players	320	144	260	413
Petroleum Subsidy (Provided in the budget)	**29**	**150**	**384**	**236**
as % of GDP	0.1%	0.2%	0.5%	0.3%
Unprovided Share of Subsidy to be Borne by the Govt	**684**	**110**	**6**	**383**
as % of GDP	***1.2%***	***0.2%***	***0.0%***	***0.4%***

Source: Budget Documents, Morgan Stanley Research, E=Morgan Stanley Research Estimates – Morgan Stanley Oil and Gas Sector Team estimates

Oil prices in INR terms are hovering near historical highs as rupee depreciation is providing upside risks. We estimate that if oil prices in US$ terms remain near US$ 110/bbl and USD/INR average 52 for Q3 and Q4, then off-budget oil subsidy would be 0.4% of GDP for F2012. A US$ 10/bbl change in oil prices increases subsidy burden by US$ 6.3bn or 0.3% of GDP.

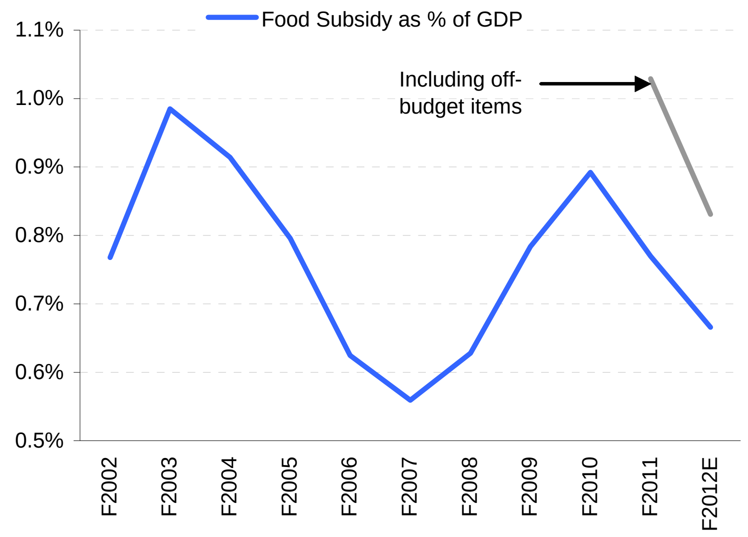
Appendix: Off – Budget Food Subsidy

Uptrend in Minimum Support Prices (MSP) for Key Crops



Source: CEIC, Morgan Stanley Research

Food Subsidy as % of GDP

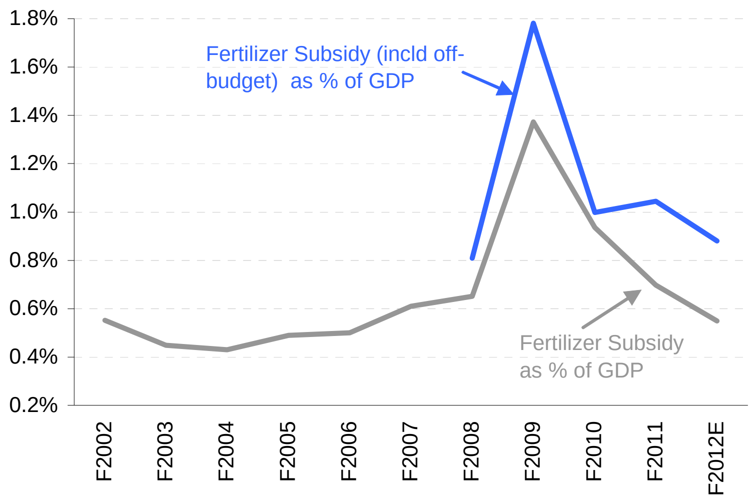


Source: Budget Documents, Morgan Stanley Research E=Morgan Stanley Research Estimates

The government subsidizes food to the poor through the public distribution system. The gap between the economic cost of food grains distributed and the issue price is increasing. The government has provided for a food subsidy burden of US$12.4 billion (0.7% of GDP) in its F2012 budget. With the cabinet nod to the Food Security bill, the estimates food subsidy is expected to increase to approx. US$ 20bn (1% of GDP)

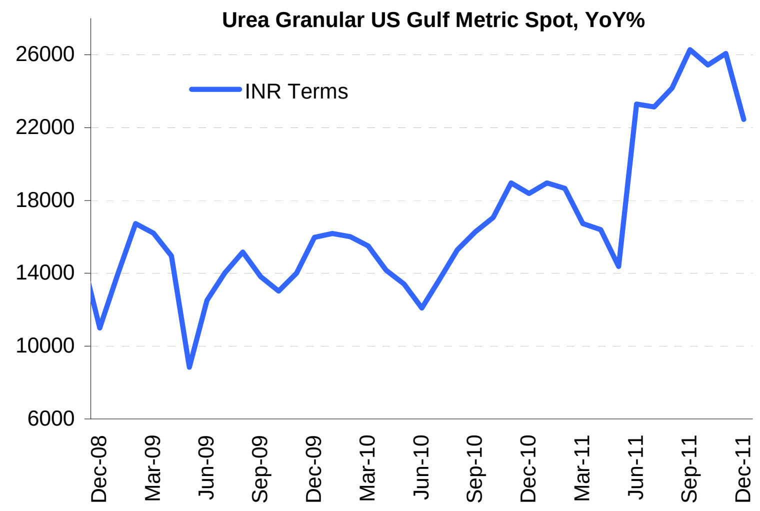
Appendix: Off – Budget Fertilizer Subsidy

Fertilizer Prices



Source: Budget Documents, Morgan Stanley Research, E=Morgan Stanley Research Estimate

Fertilizer Prices

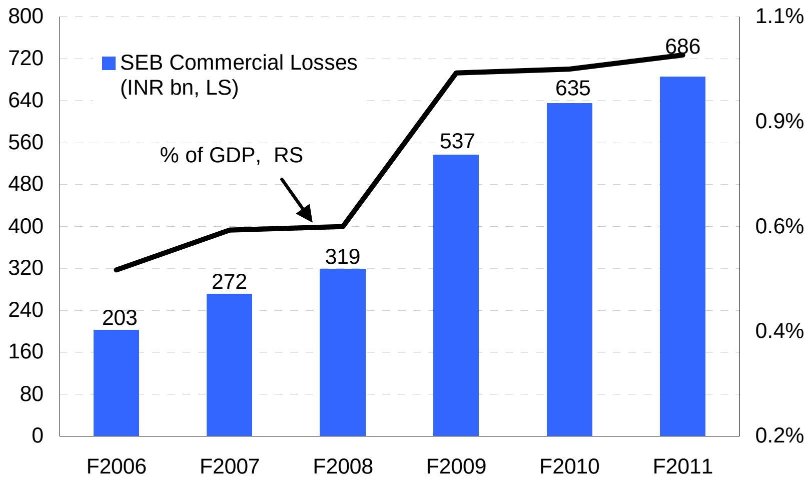


Source: Bloomberg, Morgan Stanley Research

Fertilizer subsidy is estimated to be approximately INR 800bn in F2012. The on-budget subsidy provision is INR 500bn (0.55% of GDP), thus the off-budget provision is likely to be 0.3% of GDP.

Appendix: Off – Budget SEB Losses

Aggregate Commercial Losses of SEB's



Source: Power Finance Corporation, Morgan Stanley Research

Historical Trend of Revenue & Expenditure of SEB's

INR bn	F2006*	F2007*	F2008	F2009	F2010
Revenue	1,931	2,131	2,358	2,681	2,987
Subsidies	112	129	165	157	191
Total Income	2,043	2,260	2,524	2,839	3,177
Subsidy / Revenue (%)	6%	6%	7%	6%	6%
Expenditure	2,133	2,395	2,669	3,215	3,606
Other Expenditure	-6	-4	9	4	16
Total Expenditure	2,127	2,391	2,677	3,219	3,622
Net Profit before Subsidy	-209	-267	-319	-537	-635
Net Profit after Subsidy	-97	-139	-154	-380	-445

*Source: Power Finance Corporation, Morgan Stanley Research. * Data for accounts refers to PFC report for F2009 and F2008*

State government's electricity operations continue to suffer from huge losses. While some improvement was witnessed in the early part of the 2000's, the situation has worsened again, with F2011 expectation of aggregate losses at 1% of GDP.

Appendix: Central Government Accounts

	F2007	F2008	F2009	F2010	F2011RE	F2012BE
I] Revenue Receipts (a+b)	**10.1%**	**10.9%**	**9.7%**	**8.7%**	**9.9%**	**8.8%**
(a) Tax Revenue (Net to Centre)	**8.2%**	**8.8%**	**7.9%**	**7.0%**	**7.2%**	**7.4%**
-- Gross tax revenue	11.0%	11.9%	10.8%	9.5%	10.0%	10.4%
Of Which:						
Indirect Taxes	5.9%	6.0%	5.1%	3.9%	4.4%	4.5%
-- Customs	2.0%	2.1%	1.8%	1.3%	1.7%	1.7%
-- Excise	2.7%	2.5%	1.9%	1.6%	1.7%	1.8%
-- Service Tax	0.9%	1.0%	1.1%	0.9%	0.9%	0.9%
Direct Tax	5.1%	5.9%	5.7%	5.6%	5.6%	5.8%
-- Corporation tax	3.4%	3.9%	3.8%	3.7%	3.8%	4.0%
-- Personal Income tax	1.7%	2.1%	1.9%	1.9%	1.8%	1.8%
-- *Less Share of States*	2.8%	3.0%	2.9%	2.5%	2.8%	2.9%
(b) Non -Tax Revenue	**1.9%**	**2.1%**	**1.7%**	**1.8%**	**2.8%**	**1.4%**
-- Interest Receipts	0.5%	0.4%	0.4%	0.3%	0.3%	0.2%
-- Dividends & Profits	0.7%	0.7%	0.7%	0.8%	0.6%	0.5%
II] Revenue Expenditure	**12.0%**	**11.9%**	**14.2%**	**13.9%**	**13.4%**	**12.2%**
Of Which:						
-- Interest payments	3.5%	3.4%	3.4%	3.3%	3.1%	3.0%
-- Non-Interest Revenue Expenditure	8.5%	8.5%	10.8%	10.7%	10.3%	9.2%
III] Revenue Deficit (II minus I)	**1.9%**	**1.1%**	**4.5%**	**5.2%**	**3.4%**	**3.4%**
IV] Capital Receipts (ex-borrowings)	**0.1%**	**0.2%**	**0.1%**	**0.5%**	**0.4%**	**0.6%**
-- Recoveries of Loans	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%
-- Disinvestment Proceeds	0.0%	0.1%	0.0%	0.4%	0.3%	0.4%
V] Capital Expenditure	**1.6%**	**1.7%**	**1.6%**	**1.7%**	**2.1%**	**1.8%**
VI] Total Expenditure	**13.6%**	**13.6%**	**15.8%**	**15.6%**	**15.4%**	**14.0%**
Of Which:						
-- Plan Expenditure	4.0%	4.1%	4.9%	4.6%	5.0%	4.9%
-- Non Plan Expenditure	9.6%	9.5%	10.9%	11.0%	10.4%	9.1%
VII] Fiscal Deficit (VI - I - IV)	**3.3%**	**2.5%**	**6.0%**	**6.4%**	**5.1%**	**4.6%**
VIII] Primary Deficit (VIII - Interest Payments)	**-0.2%**	**-0.9%**	**2.6%**	**3.1%**	**2.0%**	**1.6%**

RE = Government Revised Estimates, BE= Government Budget Estimate, Source: RBI, Budget Documents, Morgan Stanley Research.
*Note: *Disinvestment Proceeds in F2008 has been adjusted for one time transfer by RBI of the proceeds on account of transfer of its stake in SBI to Government of India.*

Appendix: State Government Accounts

	F2006	F2007	F2008	F2009	F2010	F2011BE
Revenue Receipts	**11.7%**	**12.4%**	**12.5%**	**13.9%**	**16.2%**	**18.3%**
Tax Revenue	8.3%	8.7%	8.8%	9.7%	10.6%	12.6%
1. State Taxes	5.7%	5.9%	5.7%	6.5%	7.3%	8.6%
2. Share in Central Taxes	2.5%	2.8%	3.0%	3.2%	3.3%	4.0%
Non Tax Revenue	3.4%	3.7%	3.7%	4.2%	5.5%	5.7%
-----Grants from centre	2.1%	2.2%	2.2%	2.6%	3.6%	3.7%
-----States own non tax revenue	1.3%	1.3%	1.5%	1.6%	1.9%	2.1%
EXPENDITURE	14.1%	14.2%	14.2%	14.9%	15.6%	14.2%
Developmental Expenditure	8.9%	9.1%	9.3%	11.4%	13.8%	14.6%
Non Developmental Expenditure	5.1%	4.9%	4.7%	5.1%	6.5%	7.3%
------Interest Payments	2.3%	2.2%	2.0%	2.1%	2.3%	2.6%
------Admin Services	0.9%	0.9%	0.9%	1.1%	1.4%	1.7%
------Pensions	1.3%	1.2%	1.2%	1.4%	1.9%	2.1%
Revenue Expenditure	11.9%	11.8%	11.6%	13.7%	17.1%	18.8%
Capital Outlay	2.1%	2.3%	2.4%	2.9%	3.2%	3.3%
Fiscal Deficit	**2.4%**	**1.8%**	**1.7%**	**2.4%**	**3.3%**	**2.6%**
Revenue Deficit	**0.2%**	**-0.6%**	**-0.9%**	**-0.3%**	**0.9%**	**0.5%**

RE = Government Revised Estimates, BE= Government Budget Estimate, Source: RBI, Budget Documents, Morgan Stanley Research.
*Note: *Disinvestment Proceeds in F2008 has been adjusted for one time transfer by RBI of the proceeds on account of transfer of its stake in SBI to Government of India.*

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