India Economics

Previewing the 2012/13 budget

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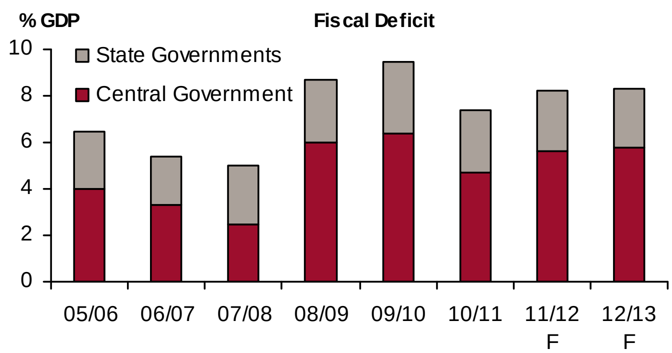
- This note is a summary of a longer report analysing India's fiscal position and previewing the country's 16 March budget.
- While India has the highest budget deficit of the Non-Japan Asian economies we cover, it would be wrong to suggest that the country is facing an unsustainable rise in government debt of the sort plaguing many developed countries. The key difference is that India's money GDP is growing at a double-digit rate.
- Nevertheless, it would still be prudent for the government to tighten the fiscal purse strings and indeed we expect the finance minister to announce a few restrictive measures. These together with an upbeat assumption about divestment proceeds and a robust growth forecast is likely to lead to an official central government budget deficit forecast of around 5%. Our own projection is for a 5.8% outturn.
- We expect the budget to deliver just about enough to allow the RBI to start cutting the repo rate at its 15 March meeting. In our view, the repo rate will be reduced 175bps by January next year, leading the 10 year bond yield to drop to 7.5% by end-2012.

Figure 1: India's budget deficits are *not* consistent with rising government debt ratio



Source: Credit Suisse, CEIC

First, the good news. India, contrary to the belief of many, is a long way from experiencing the kind of 'fiscal horror show' that has engulfed many developed world countries in recent times. While the country's (central and state) budget deficit is running at around 8% of GDP, similar to that of many western countries, India has the huge advantage of double-digit money GDP growth. With bond yields pegged back by captive buyers, in the form of the commercial banks, this means general government debt is falling rather than rising as a share of GDP in India.

But this is not to say that the Finance Ministry can relax and kick back ahead of the budget. The Reserve Bank of India, for one, will be looking for some tough measures to be delivered, while a lower budget deficit would help reduce the current account deficit and the 'crowding out' of private investment.

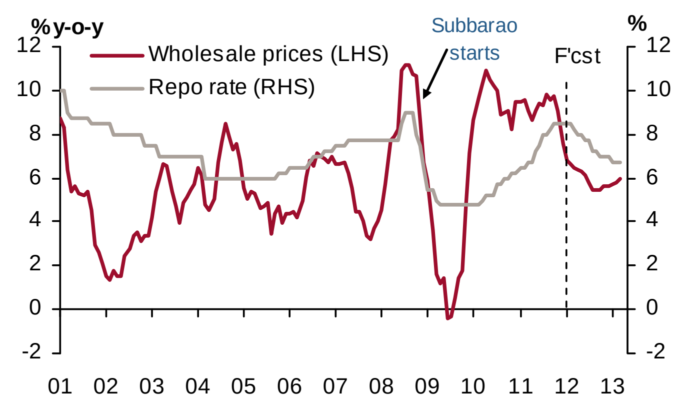
Budget measures. As such, we believe Finance Minister Pranab Mukherjee is likely to announce an increase in the breadth of the services tax and, possibly, a rise in the excise and services tax rate itself, as well as an increase in subsidised fuel prices on 16 March. He may also set out a medium-term fiscal consolidation plan, involving further details concerning the introduction of the Direct Tax Code (DCT) and Goods and Services Tax (GST), both of which have been delayed. The finance minister will, however, do well to convince stakeholders of the credibility of such a program, in our view.

Fiscal forecasts. Put such measures together with a roughly 8% real GDP growth forecast as well as an upbeat assessment of divestment and telecom spectrum receipts and we suspect Mukherjee will forecast a 5% of GDP central government deficit in 2012/13, down from a revised 5.6% in 2011/12.

RBI likely to cut rates in mid-March and beyond. Although we doubt such a figure will be achieved (we forecast a 5.8% outturn in 2012/13), we suspect the budget will deliver just about enough to start the repo rate cutting ball rolling at the 15 March RBI meeting. It seems inconceivable that the contents of the budget will not have been presented to the central bank by the time of its meeting. A further big upward move in the oil price is the main risk to this view.

We continue to look for a total of 175bps of repo rate reductions by early-2013. With wholesale price inflation falling a little further and staying in the comfort zone through 2012 and the economy experiencing a further protracted period of sub-trend real GDP growth, the RBI is likely to take back some of the 500bps in effective tightening it delivered during 2010-11.

Figure 2: RBI rates have become a lagging function of WPI inflation



Source: Credit Suisse, CEIC

We expect the curve to bull steepen and 10y bond yields to fall below 8% in 3 months and trade to 7.5% by end 2012. The easing cycle and expectations of some moderation of the significant liquidity deficit should support bonds. We do not expect much market reaction from the FY13 borrowing total, INR4.1tn net, as markets will likely be focused on RBI's policy rate actions and guidance coupled with the outlook for liquidity conditions.

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