Standard Chartered

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India – Time for a bold budget

- **FY13 budget should attempt fiscal consolidation; the deficit should shrink to 5.3% of GDP from 5.8%**
- **Expenditure compression will be difficult to achieve; the proportion of capital spend should rise**
- **Indirect tax rates might be increased and the emphasis will be on non-tax revenue to reduce the deficit**
- **RBI OMOs will be required to relieve supply pressure as gross market borrowing is likely to be INR 5.4trn**

Summary

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The Finance Minister (FM) will present the FY13 (starts 1 April 2012) central government budget on 16 March. We expect the FY12 fiscal deficit to be 5.8% of GDP (1.2% of GDP higher than the budget) but moderate fiscal consolidation should bring this down to 5.3% of GDP in FY13. Revenue growth is likely to be limited by lower nominal GDP growth in FY13 but indirect tax rates could be nudged up to provide revenue support. The new direct tax code (DTC) and uniform goods and services tax (GST) are likely to be deferred until FY14 and only a few small steps are likely to be announced to smooth the transition. Dependence on divestment proceeds and other forms of non-tax revenue are likely to continue in the FY13 budget.

The government urgently needs to reduce unproductive expenditure on subsidies to demonstrate its commitment to fiscal consolidation. Deregulation of all administered prices on fuel and fertiliser products is unlikely to happen immediately but some price increases are possible to reduce the subsidy burden and signal policy direction. Although in the near term these price corrections could be inflationary, the Reserve Bank of India (RBI) is likely to focus more on the medium-term impact of fiscal consolidation to tame structural inflation pressures. Monetary policy can only be eased substantially in FY13 if the budget outlines a credible fiscal consolidation plan. Even if fuel subsidies are brought down, new pressures could emerge from food subsidies, allocations for bank recapitalisation and debt restructuring for power distribution utilities. Overall, the expenditure-to-GDP ratio in FY13 might not improve substantially from FY12. We would view the budget positively were the FM to improve the quality of fiscal spending by increasing the share of capital expenditure (13% of total expenditure in FY12) on infrastructure projects.

The outcome of state elections on 6 March will determine the final shape of the budget. A positive result for the ruling United Progressive Alliance (UPA) could prompt the FM to take bold steps towards fiscal consolidation. The announcement of a fiscal deficit below 5% of GDP is possible, but markets would closely scrutinise all the assumptions behind such an optimistic projection. In our baseline scenario we expect gross market borrowing to be around INR 5.4trn, which is marginally higher than current market estimates. In such a case, we believe support from the RBI via open market operations (OMOs) will again be required in FY13 to avoid supply pressure in the rates markets.

FY13 budget backdrop

The macro and political backdrop of the FY13 budget could mean this is a make-or-break budget

The backdrop to the FY13 budget announcement due on 16 March is interesting from the following perspectives:

- Growth, particularly investment activity, has decelerated substantially and demands policy attention. While inflation has edged down, it has yet to settle within the RBI's comfort zone. The complexity of the macro backdrop is exacerbated by an uncertain global environment.
- The last three budgets have all been criticised as being populist, with scant regard for fiscal discipline. Therefore, returning to a sustainable fiscal path will be a policy priority.
- This is all the more important because the RBI has indicated that its ability to ease monetary policy depends on the extent of fiscal consolidation.
- The FY12 fiscal deficit could exceed the initial target of 4.6% of GDP by close to 1.2% of GDP. If so, markets would scrutinise all the assumptions behind the FY13 budget even more closely.
- The FY14 budget (to be presented February 2013) will be the last before the 2014 national elections and is likely to be a populist one. Logically, the FY13 budget is therefore the one to push through some hard decisions.
- As the FY13 budget will be presented almost immediately after the five state election results are announced; the outcome could force the FM to shift the focus of the budget to suit political needs.
- FY13 will be the first year of the 12th Five-Year Plan (FYP). A reorientation of expenditure to meet its objectives will be a critical challenge for this budget, given that close to 40% of the resource requirements for the FYP are allocated from the budget.

Strategies and issues

A credible fiscal consolidation roadmap is as important as announcing a low fiscal deficit for FY13

The path of fiscal consolidation: All eyes will be on the FY13 fiscal deficit estimate as the FM presents his budget, but it will be equally important to present a credible roadmap. The Thirteenth Finance Commission suggested a fiscal consolidation roadmap in December 2009 to bring down the fiscal deficit to 3% of GDP by FY14. According to that roadmap, the FY13 fiscal deficit should have been 4.2% of GDP. Adhering to that target will be impossible in FY13. However, committing credibly to return to this path of consolidation within a stipulated time frame will be critical to convince investors of the seriousness of government efforts. Policy makers need to acknowledge that fiscal deficit reduction should be a policy priority, much like stimulating growth, controlling inflation or redistributing wealth.

Expenditure measures to determine the quality of fiscal consolidation: Often, how government earns its revenue and where it spends it matters more than the extent of the fiscal deficit. Expenditure containment has always been the biggest challenge in India. For a brief period during FY06-07 the expenditure-to-GDP ratio was reduced to below 14% but it increased sharply to close to 16% in an effort to stimulate the economy after the 2009 financial crisis. The majority of fiscal expenditure is sticky, with very little scope for reduction. In FY12, almost half of the total spend was on interest rates, subsidies and defence. If we add around 20% of total expenditure on salaries of public-sector employees, then only 30% of the total spend is discretionary.

Reducing the number of fiscal schemes could be one way of curtailing expenditure

So, efforts to reduce expenditure can come from two broad directions. First, the deployment of resources to promote 'inclusive' growth. In the 11th FYP the government has spent close to INR 7trn (14% of total government spend during this period) on the top 13 flagship programmes of rural development and poverty alleviation to promote inclusive growth. Political considerations dictate that substantial resources need to be allocated for this purpose even in FY13; however, there is ample scope for better utilisation. Overlaps between different government-sponsored schemes need to be corrected by reducing the number of such schemes. In this context, the FM should consider the recommendations of a recent committee report which suggested reducing the number of centrally sponsored schemes to 59 from 147.

Subsidy reduction through an increase in administered prices, better targeting and increased capital spending would be important in terms of expenditure management

Second, the FM himself admitted recently that he is "losing sleep" over subsidies. While complete deregulation of diesel, cooking gas and fertiliser prices will be difficult to achieve immediately, the FM should seriously consider increasing prices to reduce the extent of the subsidy. Any step in this direction would reduce distortion and should be viewed as a positive reform. This will also be necessary because food subsidies are likely to rise substantially once the National Food Security Act is passed by parliament (expected by mid-2012) and the FM might also have to provide for bank recapitalisation in the FY13 budget. On the positive side, it is possible that he will unveil some plans for the direct transfer of cash subsidies, taking advantage of the unique identification numbers that are being assigned to the entire population. This will help to better target subsidies and could potentially reduce leakages in subsidy distribution.

Another aspect of the uneven nature of spending is that capital expenditure is only 13% of total spending now; it was close to 23% in 2004-05, during the first two years of the ruling UPA's term. When insufficient infrastructure spending acts as a drag on potential growth, there is an urgent need to increase it. Correcting this imbalance will be one of the most critical aspects of the FY13 budget.

GST and DTC are likely to be deferred but some staggered steps could be included in the budget

Staggered overhaul of the tax regime: Rising revenue generation on the back of high growth led to the fiscal deficit dropping to 2.5% by FY08 from 6% in FY02. During this period the tax-to-GDP ratio increased to 12% from 8%, a significant achievement. The tax-to-GDP ratio is again close to 10% in FY12 and the emphasis in the FY13 budget should be on increasing it. Indirect tax reductions implemented in 2008 to minimise the impact of the global financial crisis have not yet been reversed. Revenue foregone because of different types of tax incentives was 6.6% of GDP in FY11 (slightly better than 8.15% of GDP in FY09) but revenue collection could be further improved by removing some of these incentives.

Two major structural reforms to overhaul the direct and indirect tax system – a new direct tax code (DTC) and a uniform goods and service tax (GST) – are on the agenda but are unlikely to be implemented in the FY13 budget. However, the FM might want to introduce some changes in the tax structure so that the move to the new system is staggered and non-disruptive. Some of the measures expected in the FY13 budget could include a reclassification of the income tax brackets, increasing the excise and customs duties and bringing more services within the tax net. Some elements of the GST are still being debated with the states and hence some clarity on the expected timeline of the introduction of GST could be included in the budget.

Also, addressing the issue of 'black money' could arise in the budget and a tax amnesty scheme is one of the policy tools available. The last such scheme, in 1997, resulted in INR 105bn of revenue, with more than 450,000 people disclosing non-taxed income under the scheme. However, recent media reports suggest that such measures may not be included in the budget.

The government is keen to convert assets into cash flow but overdependence on this route raises question marks over sustainable fiscal consolidation

Sustainable fiscal consolidation should not be based on non-tax revenue: With the economy likely to grow below trend in FY13, the FM cannot rely on unexpected windfalls in terms of tax revenue collection. However, non-tax revenue could be an important way of achieving a lower fiscal deficit number. The government has been contemplating different mechanisms to convert assets into cash flow. In its simplest form, the government divests shares in public-sector companies to fund social-sector programmes. In FY12, the government has fallen short of its divestment target because of depressed equity markets. So, in FY13, the strategy could be to auction off these stakes to institutional investors rather than taking the IPO route. This has been made possible by recent regulatory changes. The first such transaction could take place in FY12, which would prepare the government for more such auctions in FY13. Also, there have been some innovative suggestions about how to utilise some of the government's private-sector stock holdings held in an entity called SUUTI. These assets could possibly be transferred to a special purpose vehicle which could then leverage them by borrowing from banks. The borrowed amount could then be used to participate in the public-sector divestment programme. Not all the stakeholders have yet agreed on the modalities of this scheme but the budget could indicate whether the finance ministry is considering this as an option or not.

Most of India's natural assets are government-owned. Revenue from selling the right to exploit them could be a potential source of income. In FY11, the government received more than INR 1trn from auctioning 3G spectrum. FY12 did not see any such bonanza but in FY13 the government is likely to budget substantial revenue from auctioning of 2G licences; 122 that were issued in 2008 were cancelled by a recent court order. Auctioning of new coal blocks could be another way of generating revenue. While such measures might improve the FY13 fiscal deficit, we are wary of the sustainability of such a process.

Supply-side reforms should complement any efforts of fiscal consolidation

Going beyond the fiscal deficit, planting the seeds of supply-side reforms: Although focus on the fiscal deficit estimate is inevitable, the FY13 budget will give the FM an opportunity to announce significant supply-side reform. These could be aimed at addressing some of the infrastructure bottlenecks, particularly in the power sector. Also, any clarity on land acquisition issues would be a positive.

Fiscal and monetary policy interface

Fiscal consolidation can have a near-term inflationary impact but the RBI should focus on the medium-term benefits

January's monetary policy statement emphasised that substantial monetary policy easing has to be preceded by fiscal consolidation – both the extent of the fiscal deficit and quality of fiscal spending matter. In the recent past, much fiscal spending has been in the form of cash transfers without matching asset creation. Also, the right to employment, education, food, etc., has taken the form of entitlements which do not incentivise productivity growth in the rural economy and risk creating an environment of continued dependence on such schemes. Consumption demand draws support from this fiscal stance and the impact of interest rate policy on inflation may be largely neutralised.

Another factor is that some of the possible measures to reduce the fiscal deficit could be inflationary in the short run – such as increasing the administered prices of diesel, cooking gas, fertiliser, power, etc., to reduce subsidies. The RBI is likely to support such a fiscal correction because in the medium term those price changes should reduce demand and bring down inflation. However, in the short run, it is important to ensure that inflationary expectations remain anchored, even while price corrections occur. The March monetary policy statement will be released just a day before the budget. This could make the choice of monetary policy action even more difficult.

FY12 – A year of considerable slippage

The FM is likely to confirm substantial slippage from the budgeted FY12 fiscal deficit target. Against a budgeted fiscal deficit of 4.6% of GDP, we think the government is likely to end FY12 with a fiscal deficit of 5.8% of GDP, not very different from the 6% fiscal deficit witnessed in FY09. Several factors, both on the revenue and expenditure fronts, have contributed to this slippage. We discuss these in detail below.

Indirect tax collection should meet the revised FY12 target, while net direct tax collections could fall short because of large refunds

Net tax collection has been hit: Despite a reduction in excise duty and customs duty on petroleum products at the beginning of FY12, indirect tax collection (excise, customs and services and other taxes account for 42-43% of total tax generation) has held firm. Growth of 15.1% y/y FYTD (April-January FY12) is not far from the 17% y/y growth targeted for FY12 as a whole. Indeed, with almost 80% of the targeted collection already with tax officials, much in line with the historical performance, the government is set to achieve its revised target of INR 3.92trn from indirect taxes.

Gross direct tax collection remains relatively unscathed. Personal income tax collection growth has been robust, at 20% FYTD, much in line with targeted growth. Corporate tax collection (which accounts for c.38% of total tax collection) has grown by 12%, much lower than the budgeted growth of 20%. However, this is likely to improve in the next two months. Close to 30% of corporate taxes are collected in the last quarter of the fiscal year. Thus, even as direct tax growth has slowed to 14.6% y/y FYTD, far lower than projected growth of 20% y/y for FY12, we believe significant slippage here is unlikely as we end FY12.

The biggest worry for tax collection arises from the huge tax refunds this year. For the first 10 months of FY12, tax refunds stood at INR 790bn, almost two-and-a-half times more than the previous year. Given such huge refunds, 9% growth in net tax collection versus the 20% targeted does not surprise us. According to official estimates, refunds for FY12 as a whole will be INR 200-250bn higher than in FY11, making it difficult to meet the tax collection target. Hence slippage of INR 203bn (0.23% of GDP) in net tax collection looks highly likely in FY12.

Shortfall in divestment could be partially met by higher dividend payout by state-owned companies

Non-tax revenue will not provide respite as it did in FY11: Unlike FY11 when spectrum auctions generated extraordinary revenue of INR 1.05trn (1.3% of GDP), which helped fiscal deficit consolidation, little support is expected in FY12. In fact, given the lack of clarity on regularity policies regarding spectrum auctions, the government is set to miss the targeted INR 140bn of revenues which it expected to raise via this route. Such a loss should be partially offset by additional dividend

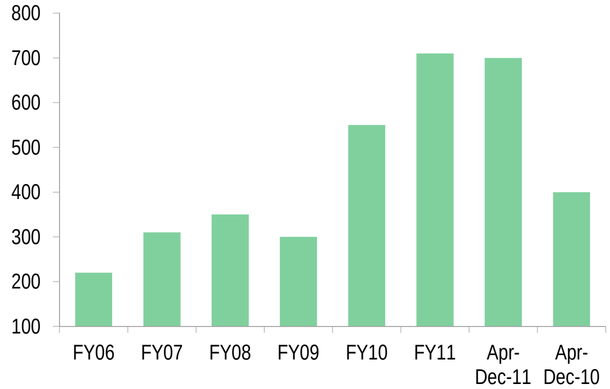
Chart 1: Tax collection as a % of budgeted collection

% of budgeted collection

Sources: Press reports, CEIC, Standard Chartered Research

Chart 2: Refunds have been higher

INR bn



Sources: CEIC, Standard Chartered Research

receipts from state-owned enterprises. However, the expected increase in dividend payments is not a consequence of better company performances. It is more a result of government persuasion to push such enterprises to raise the dividend payout to the government as revenue proceeds were expected to be below target. While INR 65bn of higher dividends have already been confirmed by some companies, we believe another INR 40bn of dividend receipts is likely. Nevertheless, marginal slippage of INR 52bn (0.06% of GDP) on non-tax revenues cannot be ruled out.

Disappointment on divestment prompts a change in strategy: With little progress on the divestment front – the government has collected INR 11bn versus a targeted INR 400bn – considerable slippage looks likely. The government now proposes to use the auction route rather than the IPO route to divest its stake in a state-owned oil company. If successful, this could partially bridge the gap, but we expect slippage of at least 0.30% of GDP on the budgeted divestment proceeds. Overall, we expect a total revenue-collection shortfall of 0.6% of GDP.

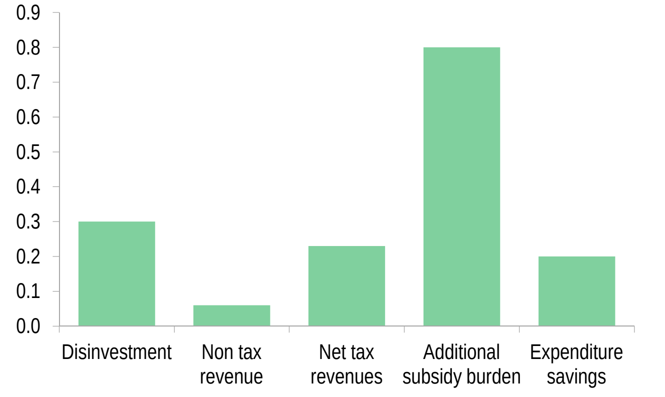
Subsidies likely to overshoot budget estimates by 0.8% of GDP but spending cap on ministries could help manage expenditure growth

Burgeoning subsidies to bloat expenditure: The FY12 budget targeted a 12.5% decline in subsidies; instead they look likely to rise significantly. Given the weaker Indian rupee (INR) and increasing oil prices, oil companies' total losses are likely to be c.INR 1.4trn. If the government bears 40% of these losses, subsidies are likely to exceed the budget estimate by INR 600bn (0.5% of GDP). Indeed, the government announced INR 450bn of subsidy payments to oil companies in the first nine months of FY12. Similarly, fertiliser subsidies could be INR 100-120bn higher than the INR 500bn target in FY12. They already breached the targeted amount by INR 50bn in the first nine months of FY12. Hence, subsidy expenditure is at risk of exceeding the target by as much as 0.8% of GDP.

However, the finance ministry has instructed other ministries not to spend more than 33% of their budgeted spend in Q4-FY12, to avoid bunching up of expenditure in the last quarter of the fiscal year. Given that several ministries were slow to spend in the first nine months, expenditure for the full fiscal year could be INR 300bn lower. Even factoring this in, expenditure is likely to be higher by 0.6% of GDP in FY12. The fiscal deficit in FY12 is likely to be at 5.8% of GDP, much wider than the initial target of 4.6%.

Chart 3: Revenue and expenditures misses

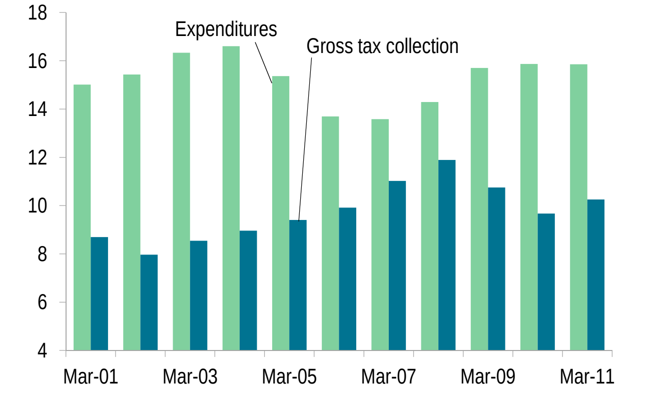
% of GDP



Sources: CEIC Standard Chartered Research

Chart 4: Slower revenues, higher expenditure

% of GDP



Sources: CEIC, Standard Chartered Research

FY13 – Back to fiscal consolidation

With such substantial slippage in the FY12 fiscal deficit target, it will be imperative that the FY13 budget puts India back on the path of fiscal consolidation. This needs to be achieved both by boosting revenues and curtailing expenditure.

An increase in income tax exemption limits could be counterbalanced by higher indirect tax rates

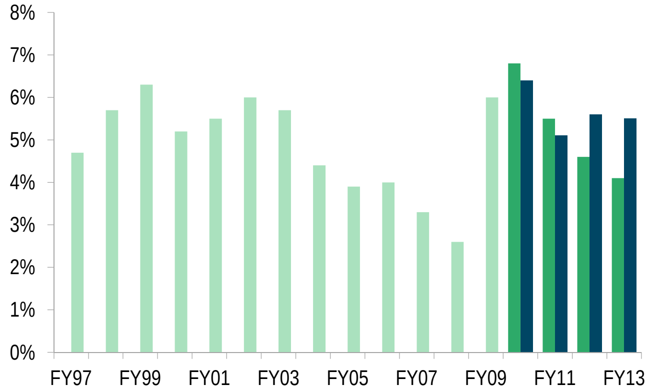
Measures needed to support tax collection: A slower nominal GDP growth (we expect it to be 14% y/y versus 15.7% in FY12) could weigh on revenue generation. Therefore the government will be conscious that fiscal austerity should not substantially dampen growth. While we do not expect a reduction in tax rates owing to fiscal constraints, an increase in the individual income tax exemption limit could be considered in order to offset inflationary pressures. This could provide some respite to private consumption. Growth in private consumption (which accounts for 60% of overall GDP) slowed to 6.5% y/y in FY12 from 8.1% y/y in FY11. Current talks indicate that the government is considering increasing individual tax exemption limits in the range of USD 415-2,500 per person. Assuming the number of tax assesses at 34.8mn, as was the case in FY11, this could provide a direct stimulus of 0.1-0.5% of GDP and have a multiplier impact on the overall economic activity as personal disposable income increases. While a corresponding loss in revenue will be inevitable, this should be offset to some extent as other tax collection improves on a higher level of economic activity.

The government could also garner some resources by withdrawing some of the tax stimulus provided post the financial crisis. A 1ppt increase in excise tax to 11% is one such widely mooted measure. This alone could boost revenue collection by c.0.2% of GDP. Given the impending implementation of GST, such a measure would have to be coupled with a similar increase in services taxes, currently at 10%. However, as the services tax collection as a percentage of GDP (0.9%) is half that of excise tax collection, the corresponding impact of a 1% increase in services taxes would be an additional contribution equivalent to c.0.1% of GDP to the tax coffers. Under GST there will be only a small list of services which will not be taxed, but ahead of this the FM might want to bring more services under the tax umbrella in FY13 and increase service tax collection. An increase in customs duty is also under consideration. However, this could have a significant impact on price pressure and might not be favoured by policy makers.

Non-tax revenues and divestment proceeds could be better: Overall revenue collection is also likely to receive some support from higher non-tax revenue collection. Specifically, spectrum auctions in FY13 are likely to provide the government with relatively higher proceeds than FY12. According to our equity analysts, spectrum

Chart 5: Fiscal deficit widens

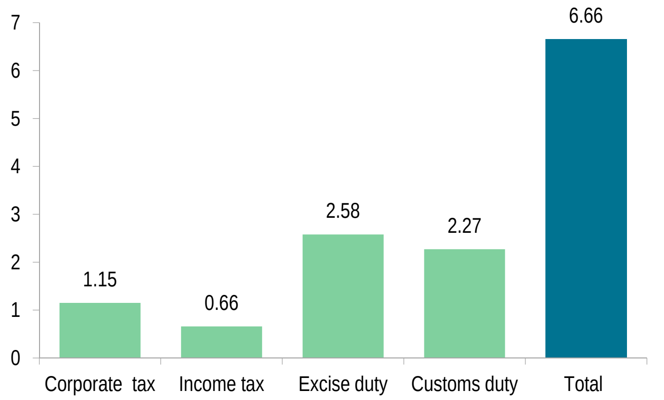
% of GDP



Sources: CEIC Standard Chartered Research

Chart 6: Revenue foregone in FY11

% of GDP



Sources: CEIC, Standard Chartered Research

auctions in FY13 are likely to generate INR 160-320bn (0.2-0.4% of GDP) of revenue. Similarly, capital receipts could be higher, as revenue realisation from divestment proceeds could be boosted by improved global economic conditions, especially in H2-FY13. It is highly likely that the government will once again target divestment of INR 300-400bn (0.3-0.4% of GDP) when it presents FY13 budget on 16 March.

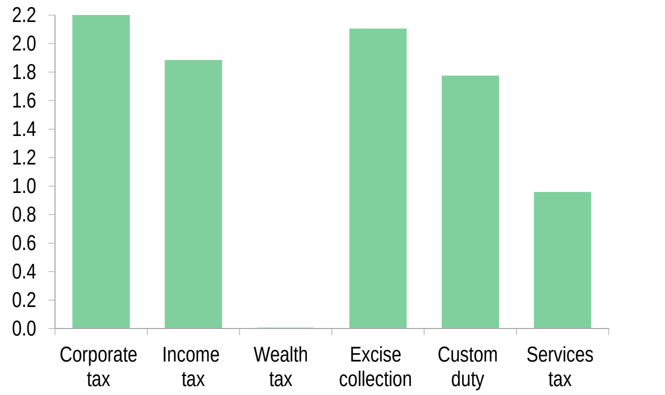
Even after price corrections, fuel subsidies are likely to remain high; additional subsidies may be included in the FY13 budget

A reduction in recurrent expenditure is necessary: While the government might have limited room to manoeuvre on most of the rigid and recurrent expenditure (interest payments, defence, subsidies and salaries), it could still take certain measures – especially related to petroleum products – to cap the overall subsidy burden. Our equity team estimates that every USD 10/bbl increase in crude oil prices increases the petroleum products subsidy burden by 0.3% of GDP. Since the Indian crude basket is expected to stay at elevated levels – we expect it to be USD 118/bbl, 8% higher than FY12 – oil company losses could be higher than the INR1.4-1.5trn recorded in FY12. If the government does not pass on any of the burden to consumers, the petroleum subsidy could once again be high, at 0.7% of GDP in FY13. However, if the government decides to increase diesel prices by INR 2/litre, kerosene by INR 1/litre and cooking gas prices by INR 50/cylinder, the fuel subsidy burden could be lower by 0.14% of GDP. Similarly, some respite is likely as the government plans to increase the price of urea and link it to the price of gas in an attempt to reduce its burgeoning fertiliser subsidy bill. For a start, it is considering increasing urea prices by a flat 10%. If the new fertiliser subsidy scheme is implemented the government could save c.0.11% of GDP.

Such savings on subsidies (up to 0.25% of GDP) are necessary to free up resources for additional subsidies which are likely to be introduced in FY13. For instance, while full implementation of the Food Security Act is unlikely in FY13, recent talks suggest that the government will allocate a token amount of INR 50bn (c.0.06% of GDP) to start this plan. More importantly, resources will be needed to provide funds for the national electricity fund (NEF) which, in turn, will subsidise the interest rate on loans taken by State Electricity Boards (SEBs) for cutting distribution losses. The SEBs have accumulated bank debt of INR 1.8trn because of huge losses incurred from selling electricity below cost and various other inefficiencies associated with electricity distribution. Given the size of this debt, SEBs are finding it difficult to raise working capital at reasonable rates. Thus we expect the government to provide them with financial support via an interest-rate subsidy of INR 250bn in the next two years. This subsidy will be performance-linked and aimed at an efficient distribution system. If implemented, it could increase the subsidy burden by c.0.13% of GDP.

Chart 7: Indirect taxes are important sources of revenue

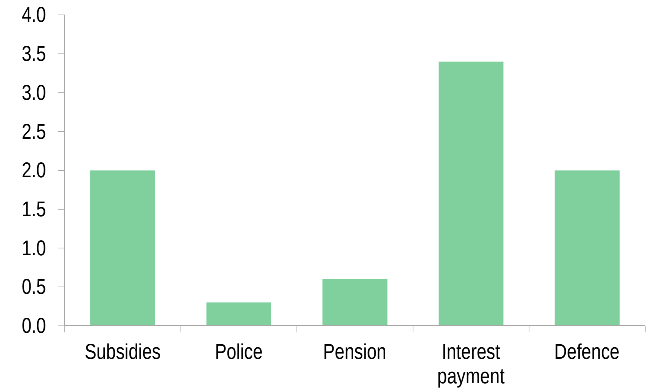
% of GDP



Sources: CEIC Standard Chartered Research

Chart 8: Most of the expenditure is rigid in nature

% of GDP



Sources: CEIC, Standard Chartered Research

Growth in spending on planned projects could be lower in FY13

Gross budgetary support might grow at a slower pace: Although the planning commission is seeking an 18% increase in gross budgetary support (GBS) – financial assistance provided by central government to planned schemes, such as the employment guarantee scheme and Bharat Nirman project – fiscal constraint might restrict this to just 11% as reported by newspapers. In FY12, the GBS increase was targeted at 16% y/y. However, as this is the first year of 12th FYP, the government might be under pressure to allocate a sufficient amount to infrastructure development.

With an improvement in the tax-to-GDP ratio and no worsening of the expenditure-to-GDP ratio, we expect a fiscal deficit to be 5.3% of GDP in FY13

Our baseline projection for the budget: Details of the budget can be finalised up to a few days before the budget. State election results due on 6 March may influence the tone of the budget statement. However, at this stage we expect the FM to announce a FY13 budget deficit target of 5.3% of GDP, marginally lower than our initial estimate of 5.5% of GDP. Our expectation is based on the assumption that the government is able to raise the gross tax collection-to-GDP ratio to 10.8% of GDP versus 10.4% in FY12 via a combination of indirect tax increases and improved economic activity. Also, higher proceeds from spectrum auctions and divestment plans should support overall revenue collection. On other hand, we assume expenditure will remain at 14.8% of GDP (14.75% in FY12). This is because any reduction in the subsidy burden is likely to be absorbed by fresh subsides and infrastructure expenditure requirements.

Under optimistic assumptions the FM can announce fiscal deficit to GDP at less than 5%, but will be difficult to achieve that target

Risk scenarios: We also look at two alternative scenarios in which the FM could forecast a fiscal deficit target either higher or lower than our core case. For instance, if excise and services taxes are increased by 2% instead of 1% each this would reduce the fiscal deficit by additional 0.3% of GDP from our core case of 5.3% of GDP. Also, if the government increases administered product prices by more than we have assumed above or provisions for a lower subsidy burden at the beginning of the year, projecting an expenditure-to-GDP ratio of 14.5% instead of 14.8% as in our core case would not be difficult. Hence, a fiscal deficit of 4.8% of GDP could easily be managed.

Similarly, if the government opts for a more populist budget, a fiscal deficit projection of 5.5% of GDP would be inevitable. For instance, if it allocates a higher amount to the Food Security Act or fails to implement the new urea policy in the budget, we could easily see additional strain on the fiscal deficit equivalent to 0.2% of GDP.

Table 1: A scenario analysis for FY13 budget

% of GDP

	Optimistic scenario	Realistic scenario	Pessimistic scenario
Gross tax	11.00	10.80	10.70
Net tax after state's share	7.57	7.42	7.35
Disinvestment	0.39	0.39	0.39
Spectrum auction	0.34	0.34	0.34
Other non tax revenues	1.33	1.33	1.33
Expenditure	14.45	14.80	14.90
of which oil subsidies	0.35	0.50	0.58
Allocation for food security	0.00	0.06	0.08
Fertiliser	0.50	0.60	0.62
Fiscal deficit,% of GDP	-4.8	-5.3	-5.5

Source: Standard Chartered Research

Government borrowing to be the same as last year but markets expect a lower amount

Our gross borrowing forecast is higher than the market's and support from RBI OMO demand will be required to alleviate supply pressure

In FY13, our estimates of fiscal financing indicate that government borrowing will be at the same level as last year. We believe the government is unlikely to end FY12 with a cash surplus significantly higher than INR 300bn, which is required to redeem c.INR 260bn worth of GoISecs maturing on 6 April 2012. In the absence of a cash surplus cushion, the government is likely to follow its historical pattern of financing c.85-90% of the fiscal deficit via market borrowing (see Table 2). This – in our most probable scenario – implies net market borrowing of c. INR 4.3-4.5trn (INR 5.2-5.4trn gross) via GoISecs and c.INR 200bn via T-bills (note that the amount of outstanding T-bills increased by c.INR 1.16trn during FY12). Our FY13 market borrowing estimate is close to the actual level the government borrowed from the market in FY12 (INR 4.36trn). Even with a market borrowing estimate similar to last year's we believe RBI support will be important to balance the demand-supply equation in FY13, albeit less than in FY12. With c.95% of FY13 redemptions due in H1-FY13, the market borrowing calendar is likely to be front-loaded in H1-FY13. As such, we expect reinvestment demand to limit the impact of a front-loaded issuance calendar on GoISec yields.

The rates market expects FY13 net market borrowing in the range of c.INR 3.8-4.2trn (INR 4.7-5.1trn gross), close to our optimistic scenario. We believe an announcement closer to the lower end of this range would boost sentiment in the immediate term and soften yields; we would expect the benchmark 10Y GoISec to soften by c.10bps.

Table 2: Market borrowing calculations

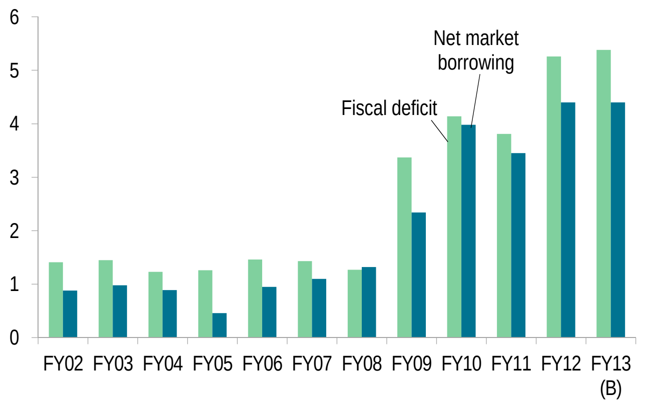
INR trn

	Optimistic scenario	Realistic scenario	Pessimistic scenario
GDP	101.50	101.50	101.50
Fiscal deficit as % of GDP	4.80	5.30	5.50
Fiscal deficit	4.87	5.38	5.58
Financing required*	4.57	5.08	5.28
Net market borrowing	4.0	4.4	4.6
Redemptions	0.91	0.91	0.91
Gross borrowing	4.9	5.3	5.5

**after deducting government's cash surplus at end-March 2012;*
Sources: MoF, Standard Chartered Research

Chart 9: Market borrowing likely to be in line with FY12

INR trn



Sources: RBI, Standard Chartered Research

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