Economic Views – India's FY23 Budget and Fiscal Risk

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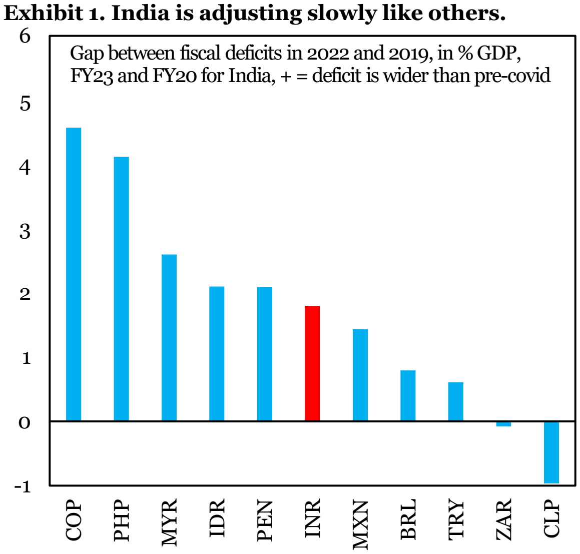
- India's FY23 budget sticks to very gradual fiscal consolidation, ...
- lifts investment and aims for mild adjustment through FY26.
- This makes the budget neutral or even a bit positive for growth, ...
- but will put pressure on yields and issuance for a long period.
- Slow fiscal adjustment is compatible with debt stabilization, ...
- because growth is still higher than in most emerging markets.

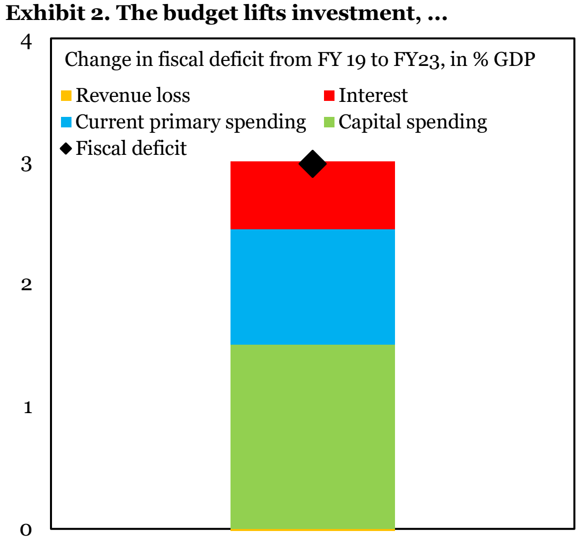
India presented a budget for FY23 targeting a fiscal deficit of 6.4% of GDP, down from 6.9% in FY22 but well above pre-pandemic levels of around 3.5%. Further but very gradual consolidation is penciled in in coming years. We assess the risk continued wide deficits pose in the context of general government debt of close to 90% of GDP. The FY23 budget is built on conservative assumptions, and we see low risk of deficit overshoots. It is neutral from a growth perspective or mildly positive if multiplier effects of high capital spending are strong. Borrowing needs will rise despite a falling deficit as the government does not plan to draw down cash buffers as much as last year. Excluding the peak of the pandemic, net issuance will be the highest since FY14 in percent of GDP but will fall well short of record levels. A mostly local investor is a structural source of demand for bonds but borrowing costs will likely rise further given years ahead of wide fiscal deficits. Despite slow fiscal consolidation, India has a good chance of stabilizing and even reducing debt levels. Growth is still high by EM standards, which makes relatively large fiscal deficits compatible with manageable debt ratios.

Exhibit 1. India is adjusting slowly like others.



Source: Budget documents, IIF

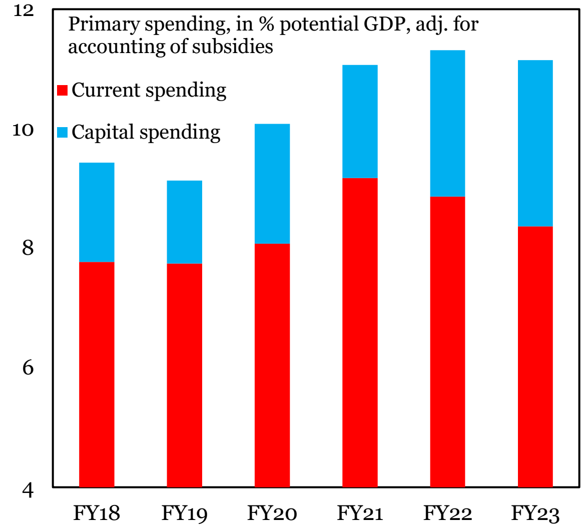
Exhibit 2. The budget lifts investment, ...



Source: FY23 budget, IIF

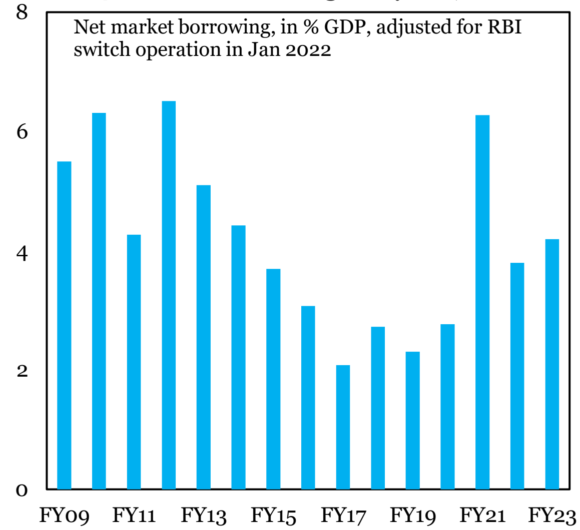
India spent less than most EMs to cushion the covid blow but a deep recession widened the fiscal deficit to about 9% of GDP in FY21. As a reference point, the fiscal rule mandates deficits of no more than 3% of GDP. Consolidation in the fiscal year that ends next month, FY22, was mild. The FY23 budget (Apr 2022 to Mar 2023) sticks to this approach, shrinking the deficit to 6.4% of GDP from 6.9% in FY22. In cross-country perspective, India's gradual adjustment does not stand out as particularly slow. Several EMs are farther away than India from pre-covid fiscal deficit levels (Exhibit 1). The budget is based on conservative nominal growth and tax revenue assumptions and is not unrealistically ambitious on the privatization front. The government expects 0.3% of GDP in privatization receipts, not far from the 0.2% of the last few years. In contrast, the FY22 budget aimed for 0.8% of GDP, which was subsequently revised down to 0.3%. Spending on subsidies may be higher than budgeted given high oil prices but on balance the budget is conservative. Capital spending, which will be the highest since FY05, explains the bulk of the gap relative to pre-covid deficits (Exhibit 2). The interest bill has risen 0.6% of GDP and will be an enduring legacy of the covid crisis that will make an eventual return to 3% deficits hard. We think that on the spending side the budget is broadly neutral for growth or mildly positive if we attach a high multiplier to capital spending and assume full execution (Exhibit 3). Relatively growth-neutral budgets have been theme in India through the covid crisis. The fiscal impulse never turned sharply positive, making large adjustment more avoidable than elsewhere in the recovery.

Exhibit 3. ... and is neutral for growth.



Source: FY23 budget, IIF

Exhibit 4. Issuance will be high for years, ...

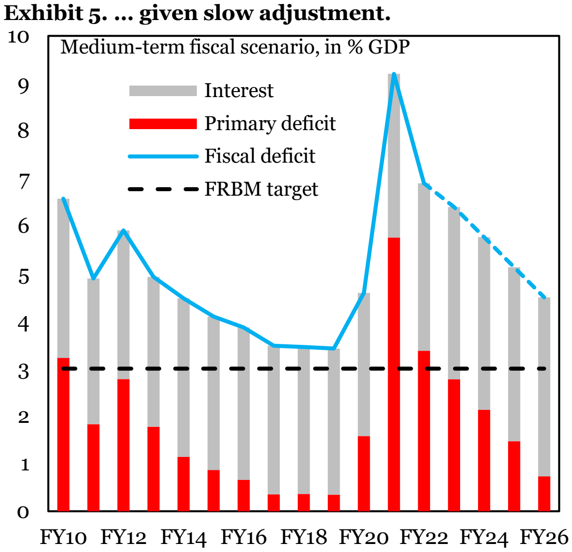


Source: FY23 budget, IIF

The flipside of still elevated deficits is sizable bond issuance. Cash buffers are still unusually high, but the government will not use them as much as last year. Borrowing from the NSSF, which pools money from several small savings schemes, will also decline, pushing up net issuance (Exhibit 4). Relative to GDP, net issuance will be the highest since FY14 and is likely to remain elevated in coming years, as the government retained its indicative deficit target of 4.5% of GDP in FY26 (Exhibit 5). This will be less demanding in terms of spending cuts than converging fast to the 3% fiscal rule but will come at the cost of higher issuance and further increases in borrowing costs, which are now approaching mid-2019 levels, having dropped sharply during the covid crisis. In this context, a mostly domestic investor base reduces rollover risk somewhat but may not stop yields from drifting higher. Inclusion in bond indices, which could attract foreign flows, does not appear imminent as the budget did not make the tax changes that are needed for inclusion.

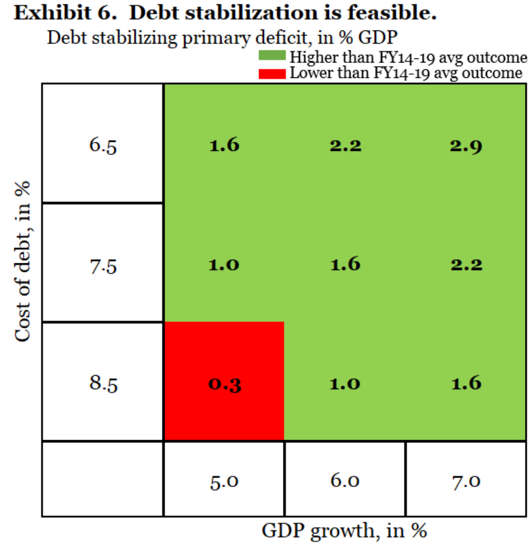
The risk that a slow fiscal adjustment strategy entails depends on how likely it is to stabilize debt. We are positive on that front. Hitting a fiscal deficit of 4.5% in FY26 calls for shrinking the primary deficit to about 0.7% of GDP from 2.8% in FY23. Whether a 0.7% primary deficit is low enough to make debt decline depends on how high GDP growth will be relative to borrowing costs. Unless average borrowing costs rise above 8% and growth falls to 5%, India's implicit medium-term primary deficit target is low enough to stabilize debt (Exhibit 6).

Exhibit 5. ... given slow adjustment.



Source: FY23 budget, IIF

Exhibit 6. Debt stabilization is feasible.



Source: Haver, IIF

