Mizuho Insights: India

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Lavanya Venkateswaran, Market Economist

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India – Mind the Fiscal Gap

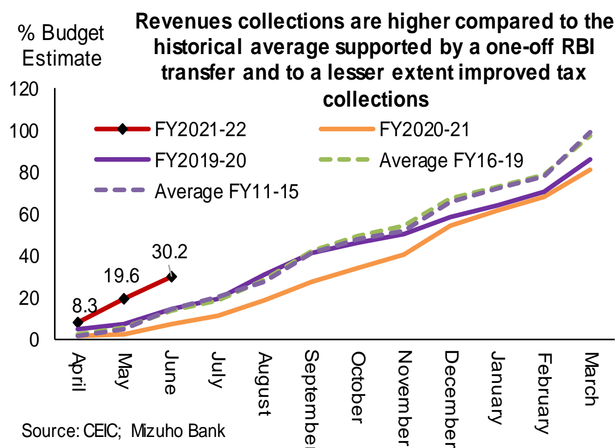
In a nutshell: The **fiscal deficit for the first quarter of FY 2021-22** (April to June 2021) was **markedly improved compared** to a year ago. **However**, we would caution against projecting an overly optimistic fiscal outlook as this was **flattered by a one-off revenue transfer from the RBI**. Moreover, fiscal **spending was probably hampered by the devastating second wave of COVID-19** (at its worst April-May). There are, however, some encouraging signs including a steady pick-up in tax revenue collections from GST and customs that constructively rein in the fiscal deficit.

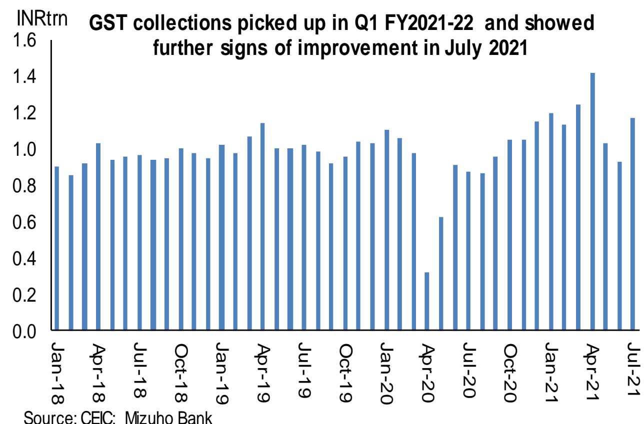
For the full year, the government still expects the **fiscal deficit to narrow to 6.8% of GDP from 9.2% of GDP in FY2020-21**. While the fiscal package announced in June, focussed mainly on credit and liquidity support measures, is not likely to detract from this deficit target the **unpredictable COVID-19 situation remains the biggest headwind**. **Another wave** of infections would **setback economic activity** and **put pressure on the government's fiscal deficit and debt profile**. With Fitch and Moody's placing India's 'BBB-'/'Baa3' (lowest investment grade) ratings, respectively, on 'Negative' outlook, a **disproportionately high-impact one-notch downgrade to non-investment grade is a risk not to be dismissed**.

Encouraging, Albeit Overstated, Fiscal Improvement

India's fiscal position for the first quarter of FY2021-22 (i.e. April to June 2021) suggests dramatic improvements are underway. However, a close look at the details shows a more mixed picture.

Although **revenue collections** hit 30.2% of the total amount budgeted in the first quarter of FY2021-22 (i.e. April to June 2021), high by historical standards (Figure 1), much of this was contributed by 'non-tax' revenues, which has already achieved 52.4% of the budget estimate (BE). Within this, 'dividends and profits' are almost near their annual target with the Reserve Bank of India (RBI) confirming that it had "complemented" revenues with a "higher than budgeted surplus transfer in May"[1]. This front-loading of the dividend payments suggests that going forward for the remainder of the fiscal year tax revenue collections will need to be, disproportionately, responsible for overall revenue collections.



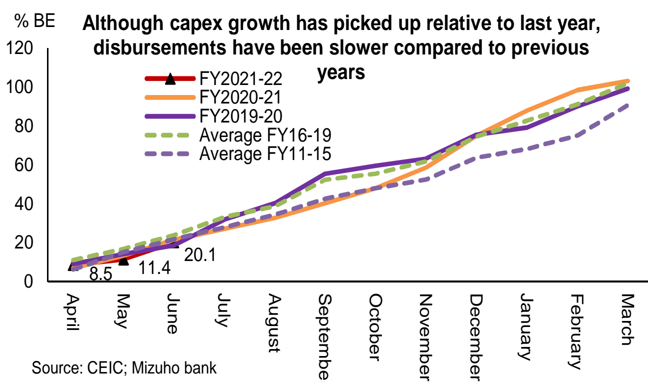


To that end, things are looking up but the picture is more of gradual improvement as opposed to a dramatic U-turn. **Gross tax revenues, which hit 24.0% of the BE in Q1 FY2021-22,** grew steadily as the quarter progressed on

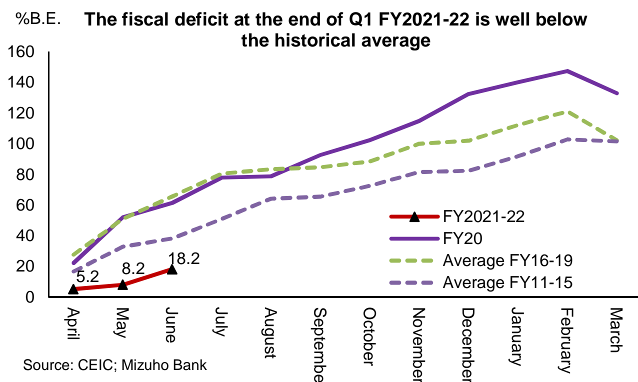
[1] RBI Bulletin July 2021 and RBI To Transfer Rs 99,122-Crore Surplus To Government, *BloombergQuint*, 21 May 2021.

account of better compliance as well as increased economic activities compared with the same period last year. Specifically, GST collections picked up in Q1 FY2021-22 but encouragingly, showed signs of further traction in July 2021 (Figure 2). This underscores a gradual normalisation in economic activity as lock down conditions were eased into June/July, after the devastating wave of COVID-19 infections abated from its peak in April/May.

Meanwhile, expenditure growth has also improved with fairly even levels of attention being given to capital and current expenditures in terms of disbursement priorities. **Total expenditures reached 23.6% of BE in Q1 FY2021-22.** Within this, capital expenditures reached 20.1% of the BE and excluding loans disbursed, increased 41.1% YoY. The disbursement rate of capex, however, is still lower compared to the same period historically (Figure 3). To some extent, this is unsurprising considering the brutality of the second wave of COVID-19 during April and May, which diverted the focus of government spending away from capex towards healthcare priorities. That said, the rate of disbursement picked up sharply in June reflecting a reprioritising of spending objectives.



Source: CEIC; Mizuho bank



Source: CEIC; Mizuho Bank

Revenue expenditures (i.e. operational expenditures) touched 24.2% of the BE but fell by 2.4% YoY; excluding interest payments the drop was even steeper at -7.3% YoY. Within this, subsidy related spending declined with lower petroleum and fertiliser subsidy expenditures more than offsetting higher food subsidy spending.

Fiscal Strains Revealed

Admittedly, the fiscal package announced in June 2021 **increases outlay for fertiliser subsidy** spending by INR0.15trn (0.07% of GDP) as well as **increased provision for food grains**; implying that the **overall spend on food and fertilizer subsidies could pick up in the coming months**. But **beyond such urgent rural/farm subsidy support**, the underlying **fiscal strains are revealed in a budget designed to minimize bottom-line impact**; which offers critical liquidity/credit support (rather than outright outlays) that will help mitigate liquidity risks spilling over as a solvency crisis.

Accordingly, **Q1 FY2021-22 fiscal deficit at 18.2% of the BE is substantially lower compared to the historical run rate (Figure 4)**. In all likelihood, the one-off non-tax revenue may absorb the 0.2-0.3pp widening in fiscal deficit that would have been otherwise expected. The forward-looking risk though is that with one-off, exceptionally large RBI transfers less likely to be repeated, **any adverse economic shocks requiring an emphatic fiscal response will revive risks of significant fiscal deterioration**; consistent with underlying fiscal strains.

Fiscal Consolidation Belies Debt Vulnerabilities

For FY2021-22, the government has maintained it deficit target of 6.8% of GDP from an actual outturn of 9.2% of GDP in FY2020-21, which was 0.3pp below the revised estimate. Provisional data shows that actual revenue collections for the previous fiscal year (2020-21) outperformed the FY2020-21 Revised Estimate (RE) while capital expenditures were modestly below the RE. These two factors offset the overshoot in revenue expenditures relative to the BE (Table 1).

INRtrn	2019-20	2020-21			2021-22		
	Actuals	Budget Estimate (BE)	Revised Estimate (RE)	Prov. Actuals	Budget Estimate (BE)	April-June 2021	% BE
Revenue	**16.8**	**20.2**	**15.6**	**16.3**	**17.9**	**5.4**	**30.2**
Gross Tax	20.1	24.2	19.0	20.2	22.2	5.3	24.0
Corporate Tax	5.6	6.8	4.5	4.6	5.5	1.2	22.6
Income Tax	4.9	6.4	4.6	4.7	5.6	1.2	21.9
Customs Tax	1.1	1.4	1.1	1.3	1.4	0.4	30.4
Non tax revenues	3.3	3.9	2.1	2.1	2.4	1.3	52.4
Dividends and Profits	1.9	1.6	1.0	1.0	1.0	1.0	98.2
Non-debt Receipts	0.7	2.2	0.5	0.6	1.9	0.1	3.9
Expenditure	**26.9**	**30.4**	**34.5**	**35.1**	**34.8**	**8.2**	**23.6**
Revenue	20.1	26.3	30.1	30.9	29.3	7.1	24.2
Interest Payments	5.8	7.1	6.9	6.8	8.1	1.8	22.8
Subsidies	2.6	2.6	6.5	6.9	3.7	1.0	27.1
Food	1.1	1.2	4.2	5.3	2.4	0.8	33.8
Fertiliser	0.8	0.7	1.3	1.3	0.8	0.2	21.0
Petroleum	0.4	0.4	0.4	0.4	0.1	0.0	8.4
Capital	3.1	4.1	4.4	4.2	5.5	1.1	20.1
Fiscal Deficit	**9.3**	**8.0**	**18.5**	**18.2**	**15.1**	**2.7**	**18.2**
% GDP	-4.6	-3.5	-9.5	-9.2	-6.8		

Source: CEIC; RBI; Mizuho Bank

Even with the fiscal deficit slightly below the RE for FY2020-21, the public debt[2] (central government) **and concomitantly, the general government debt** (which also includes state government debt) **profile remains India's Achilles heel.** According to the latest data released by the MOF, public debt hit 51.9% of GDP for year ending March 2021. This is compared with 42.3% of GDP for the year ending March 2020. As a result, general government debt[3] is now hitting up against 90% of GDP.

Resulting in Sub-Optimal Fiscal Support

This deterioration in the debt profile will continue to preclude the Indian government from being generous in its fiscal packages, aimed at offsetting some of the negative impact from the pandemic. In the fiscal packages announced since the onset of the pandemic in March 2020, the government has been conspicuously restrained in direct monetary support to households and businesses in the form of cash handouts and/or wage compensation pay outs[4]. Instead, it has resorted to providing credit/liquidity support, which while justified beyond doubt, does not alleviate the immediate balance-sheet crunch facing the poorest households and small businesses.

[2] "Public debt" defined as sum of "internal debt" and "external debt", but excludes "Public Account Liabilities" (including the latter will be "Total Liabilities"

[3] This is from the RBI's calculation of Central Government liabilities.

[4] Most other countries including the ASEAN-5 (Indonesia, Malaysia, Philippines, Singapore and Thailand) have provided cash handouts or more direct wage loss compensation measures.

Precarious Credit Ratings Risk

But the fiscal predicament is understandable given that a **potentially high-impact credit ratings downgrade risk is not insignificant**, the need to keep fiscal/debt metrics in check remains imperative. Point being, **Fitch, and more recently Moody's, lowering India's sovereign credit rating outlook to 'Negative', a downgrade cannot be ruled out over the next 12 to 18 months; especially if the COVID-19 situation takes a turn for the worse (Table 2)**, forcing the government to increase fiscal support, while revenues get impaired for longer. Although India expects to grow out of its worsening debt profile in FY2021-22, the debt dynamic remains precarious **as a highly unpredictable COVID-19 situation with the rising risk of an impending third wave**[5] means that India is not out of the woods.

Country	Rating/Outlook	Fitch	S&P	Moody's
China	Rating	A+	A+	A1
	Outlook	Stable	Stable	Stable
India	Rating	BBB-	BBB-	Baa3
	Outlook	Negative	Stable	Negative
Indonesia	Rating	BBB	BBB	Baa2
	Outlook	Stable	Negative	Stable
Malaysia	Rating	BBB+	A	A3
	Outlook	Stable	Negative	Stable
Philippines	Rating	BBB	BBB+	Baa2
	Outlook	Negative	Stable	Stable
Singapore	Rating	AAA	AAA	Aaa
	Outlook	Stable	Stable	Stable
Thailand	Rating	BBB+	A-	Baa1
	Outlook	Stable	Stable	Stable
Vietnam	Rating	BB	BB	Ba3
	Outlook	Positive	Positive	Positive

Source: Bloomberg; Fitch Ratings, S&P, Moody's, Mizuho Bank. Note: These are Local Currency Long Term ratings

Red highlight denotes a rating/outlook downgrades in the last 12 months; Yellow highlight denotes downgrades in the last 12-24 months

Green highlight denotes rating/outlook upgrades in the last 12 months

With **India's sovereign rated at the lowest investment grade rating by all 3 major rating agencies**, **a one-notch downgrade will entail a level shift down to non-investment ("junk") grade**. And insofar that **could trigger forced retrenchment of Indian bonds by funds mandated to only invest in "investment grade" assets**, the **adverse impact on India asset markets and rupee may be disproportionally large**. Such large capital outflows, may in turn kick off negative feed-back loops between a slumping rupee and exacerbating the government's debt servicing burden. Simply put, a **ratings downgrade risks triggering an unwelcome vicious fiscal-asset market-real economy cycle**.

The bottom-line is that although FY2021-22 started off with encouraging fiscal math started, headwinds to growth from repeated and potentially more severe waves of COVID-19 infections warrants caution. The silver lining is that a pick-up in economic activity, which in turn bolsters tax revenue collections, allows for fiscal consolidation to remain on track without compromising on public capital expenditure. G**rowing out of the fiscal deficit and debt remains the first best option** and **ratings agencies giving appropriate time by looking through the pandemic pain, rather than hastening to enact unhelpful, pro-cyclical moves, is imperative** **to this end**.

[5] Forecaster Who Saw India's Covid Peak Sees New Wave Coming, *Bloomberg*, 2 August 2021.

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