panorama

February 2024

Key Insights:

FY25 budgeted capex remains robust, while rural spending witnesses muted growth

- Increase in capital spending has been the primary contributor to the higher fiscal deficit compared to FY19
- Government has trimmed spending post-pandemic, particularly on subsidies, for fiscal consolidation
- Capital expenditure as a % of GDP and total expenditure continues to improve in FY25 budget estimates
- Rural spending witnesses muted growth of 2.6% YoY in the FY25 interim budget
- Allocation to rural housing has significantly increased as the government prioritises middle-class housing

Fiscal consolidation, reduced borrowing, and conservative estimates favour the debt market

- FY24 direct collections could exceed revised estimates, potentially leading to higher collections in FY25 as well
- Aggressive fiscal consolidation limits the amount of borrowing needed to finance the deficit
- Small savings collections might surpass budget estimates, potentially reducing the Centre's borrowing needs
- G-sec supply-demand outlook appears favourable, with large FPI debt flows expected due to index inclusion

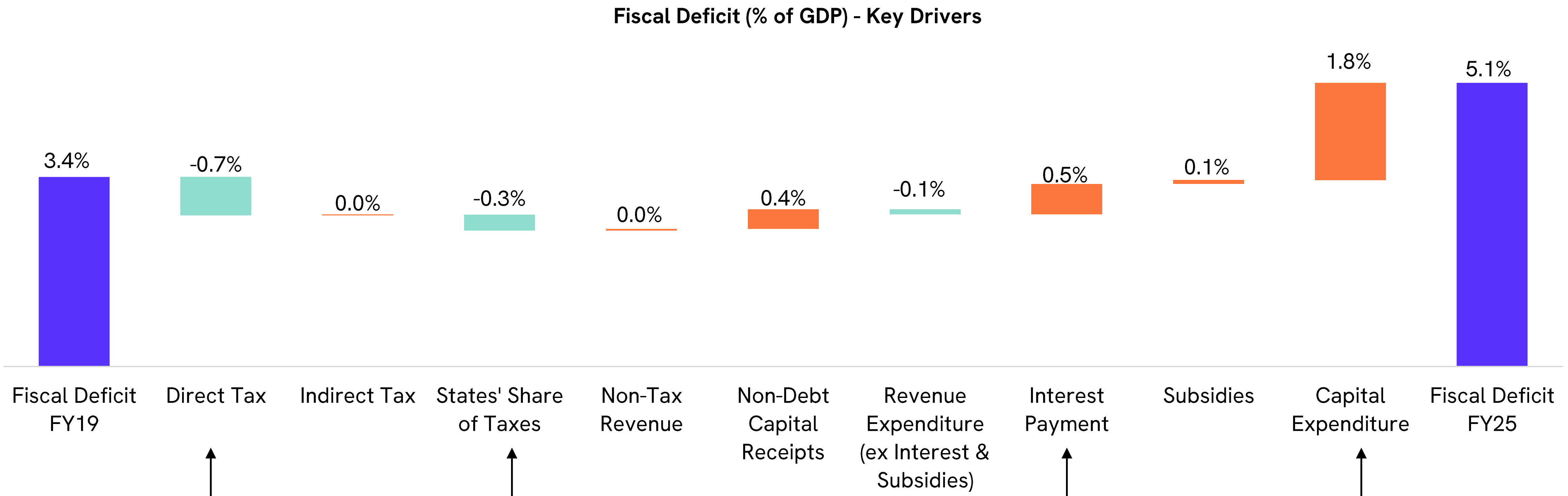
Short-term rates should ease as pick up in government spending improves liquidity conditions

- Banking system liquidity conditions remain in deficit due to large government balances with the RBI
- Short-term rates should ease as liquidity conditions improve, and the RBI's rate-cut cycle is factored in
- However, RBI could undertake OMO sales to keep liquidity conditions close to neutral in FY25
- Changing market expectations of the Fed rate cut cycle could also increase volatility

Budget & Debt Market Outlook

Higher capital spending raises the fiscal deficit compared to FY19

Improved direct tax collections and lower devolution to states cushion the impact on the Centre's finances



Improved compliance and increased formalisation of the Indian economy have led to significant improvements in direct tax collections

The 15th Finance Commission decreased states' share of taxes by 1% to 41% for the period 2020-2026

Interest payments have increased as the government ramped up borrowings to fund higher expenditures during the pandemic

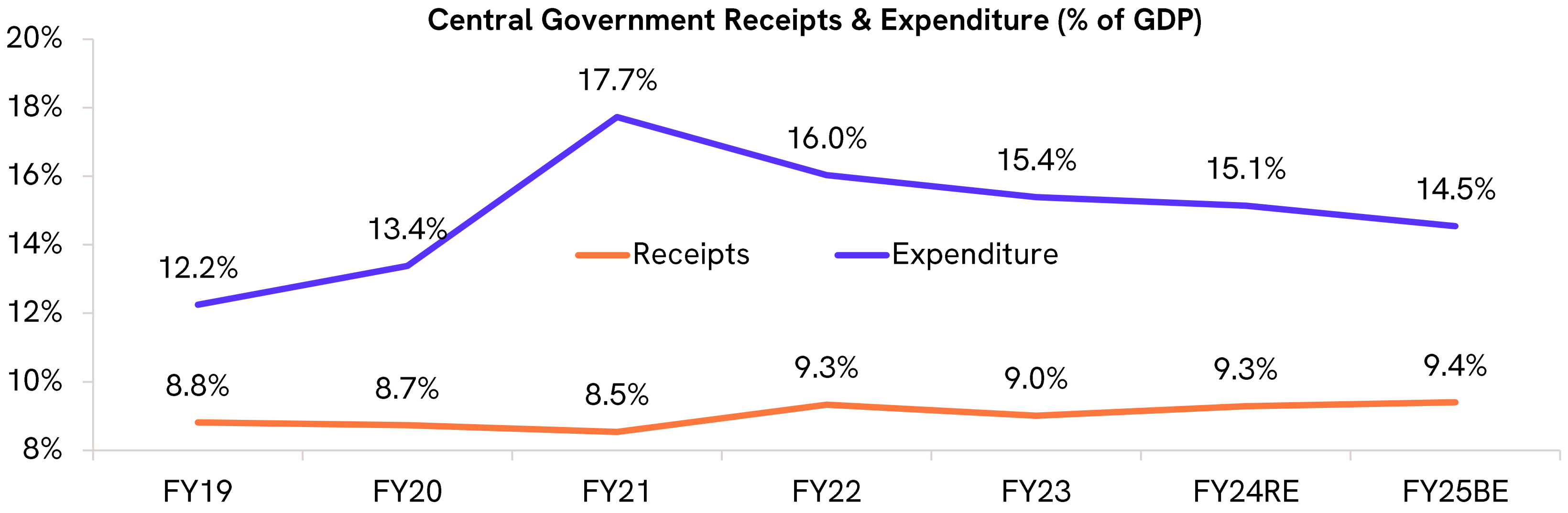
The increase in the fiscal deficit from FY19 primarily stems from a substantial increase in capital expenditure by the government

Source: CMIE, Budget Documents, 360 ONE Asset Research

Note - FY25 fiscal deficit budget estimate

Centre has steadily decreased spending to achieve fiscal consolidation

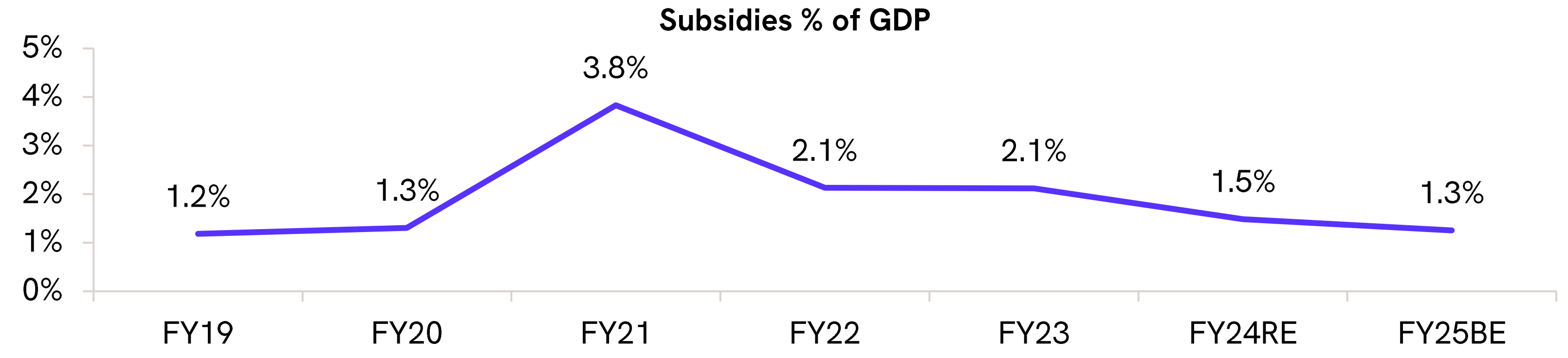
Expenditure on subsidies has significantly decreased as the government rolled back pandemic-related support



The Central Government's expenditure as a percentage of GDP is budgeted to decrease to 14.5% in FY25 from its peak of 17.7% in FY21 during the pandemic

Net receipts are also expected to improve to 9.4% of GDP from 8.5% during the same period

Overall, fiscal consolidation has been driven more by a reduction in expenditure than by an improvement in receipts



The primary factor behind the lower expenditure is a substantial reduction in subsidies

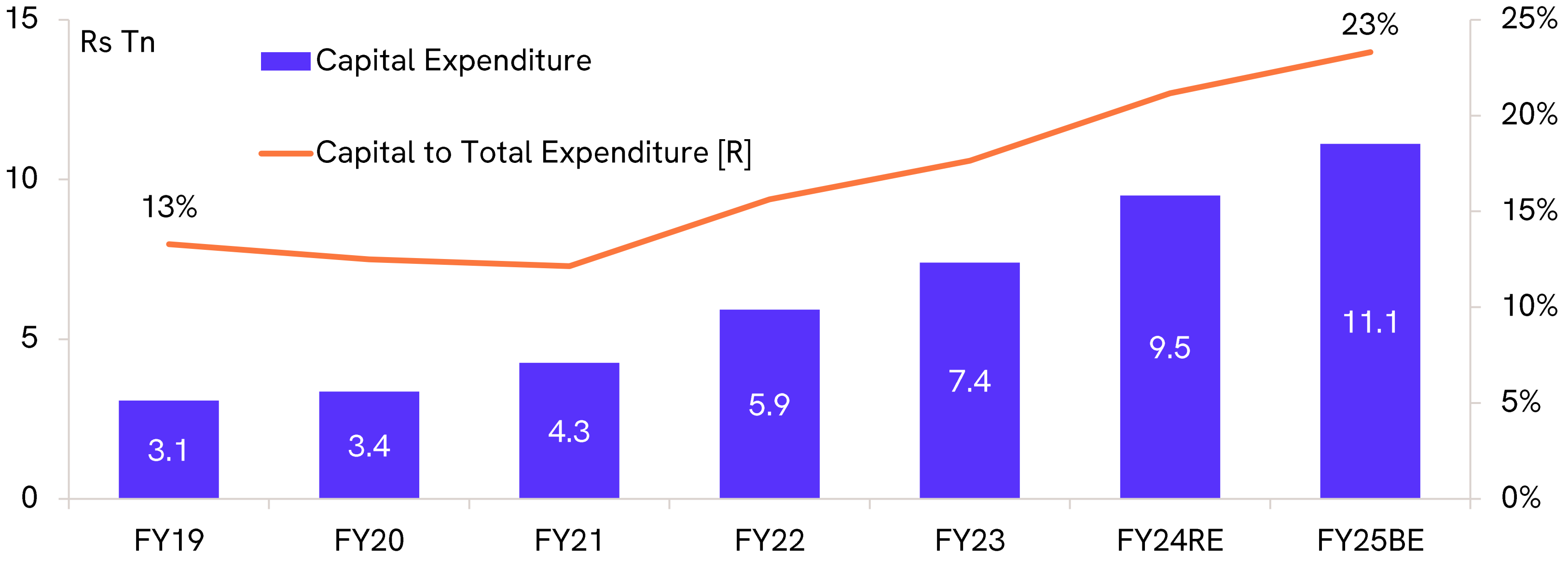
Subsidy expenditure as a percentage of GDP is projected to decrease to 1.3% in FY25 from 3.8% in FY21

Source: CMIE, Budget Documents, 360 ONE Asset Research

Note - RE: Revised Estimates, BE: Budget Estimates

Continuous improvement in the quality of government spending

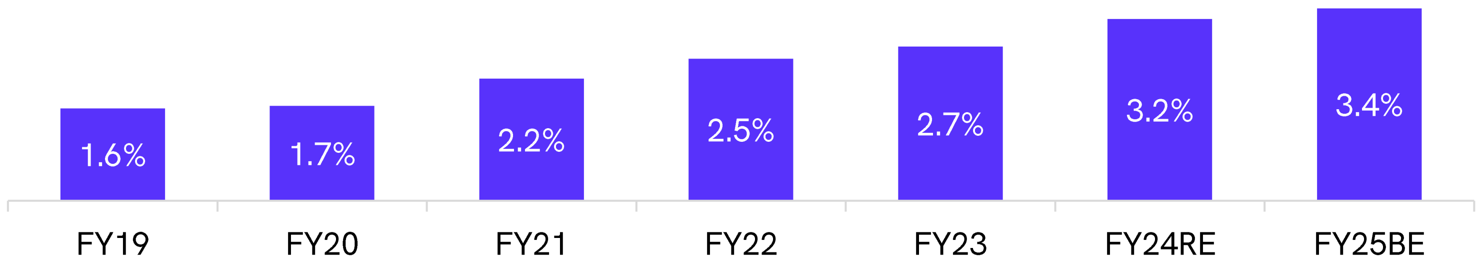
Capital expenditure (% of GDP) continues to show steady improvement and has more than doubled since FY19



The share of capital expenditure in total budgeted expenditure has increased from 13% in FY19 to 23% in FY25 BE

Capital expenditure has grown at a CAGR of 24% during this period, compared to 11% growth over the previous six years

Capital Expenditure (% of GDP)



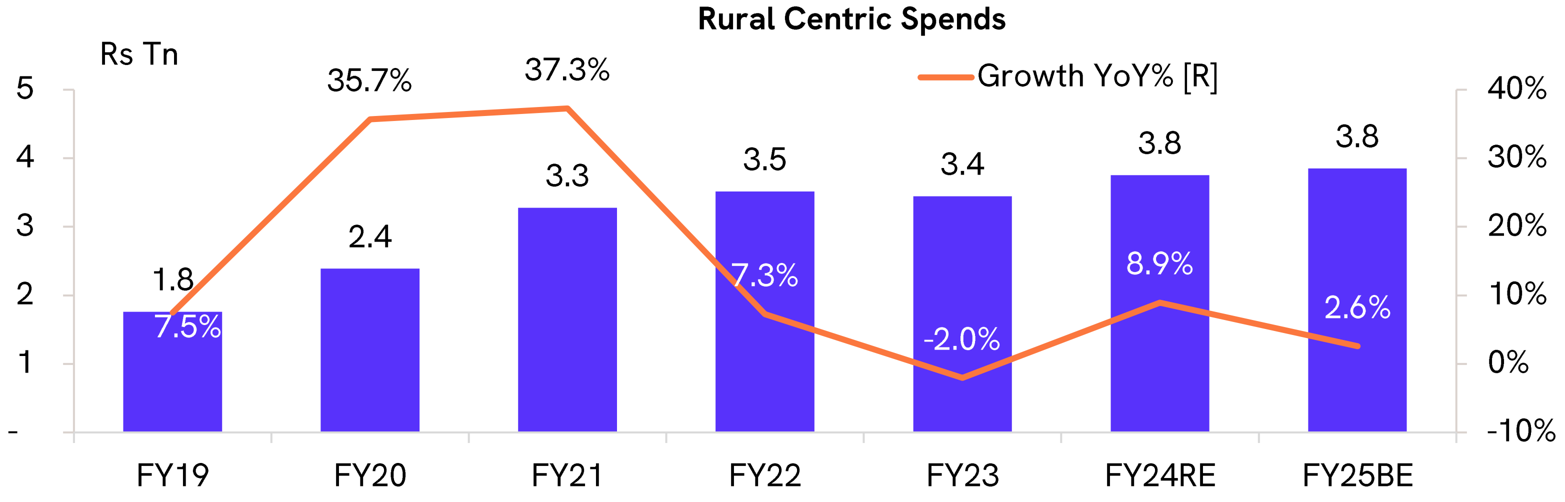
Capital expenditure as a percentage of GDP has more than doubled to 3.4% in the FY25 budget estimates from 1.6% in FY19

Source: CMIE, Budget Documents, 360 ONE Asset Research

Note - RE: Revised Estimates, BE: Budget Estimates

Rural spending witnesses muted growth in the FY25 interim budget

Rural housing scheme receives a substantially higher allocation as the government prioritises housing for the middle-class



In the FY25 budget estimates, rural-centric spending (excluding food or fertilizer subsidy-related expenses) has experienced a subdued growth of 2.6% YoY, down from 8.9% YoY in the FY24 revised estimates

Rural Focused Schemes	Rs Bn			% YoY		
	FY23 A	FY24 RE	FY25 BE	FY23 A	FY24 RE	FY25 BE
Pradhan Manti Gram Sadak Yojana	188	170	120	34%	-9%	-29%
Pradhan Mantri Awas Yojna (PMAY) - Rural	450	320	545	50%	-29%	70%
National Rural Drinking Water Mission	547	700	702	-13%	28%	0%
National Rural Employment Guarantee Program	908	860	860	-8%	-5%	0%
Pradhan Mantri Kisan Samman Nidhi (PM-Kisan)	583	600	600	-13%	3%	0%

There is a notable reduction in the allocation to rural roads scheme, while expenditure on piped water, rural employment guarantee, and income support to farmers remains unchanged

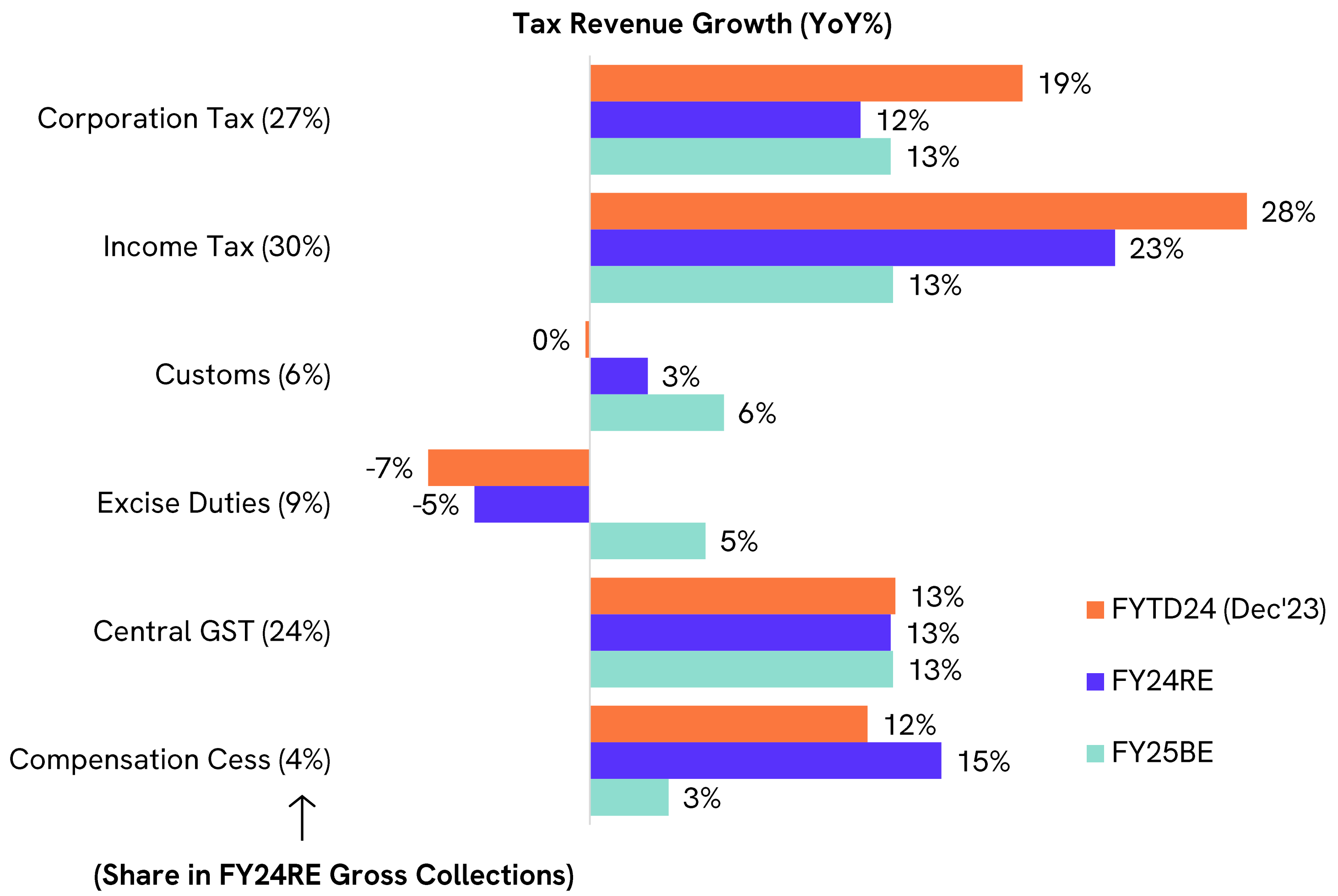
The rural housing scheme has witnessed a significant increase in allocation as the government prioritises housing for the middle class

Source: CMIE, Budget Documents, 360 ONE Asset Research

Note - RE: Revised Estimates, BE: Budget Estimates, Rural Centric Spends includes expenditure of 'Ministry of Agriculture and Farmers Welfare', 'Ministry of Fisheries, Animal Husbandry and Dairying', 'Ministry of Rural Development' and 'National Rural Drinking Water Mission'. It does not include food and fertilizer subsidy-related expenditure

FY24 direct tax estimates are conservative, and actuals could be higher

The estimated growth of the FY25 compensation cess is also conservative and could exceed expectations



Direct tax collection growth estimates for FY24 are conservative

Corporation tax collections are assumed to grow by 12% YoY in FY24, while the current run rate is 19%

Similarly, income tax collections are assumed to grow by 23% YoY, which is lower than the current growth rate of 28%

Hence, there is potential for FY24 direct collections to be higher than the estimates, and consequently, FY25 collections could also be higher than budgeted

Customs and excise duties collection estimates are realistic and achievable

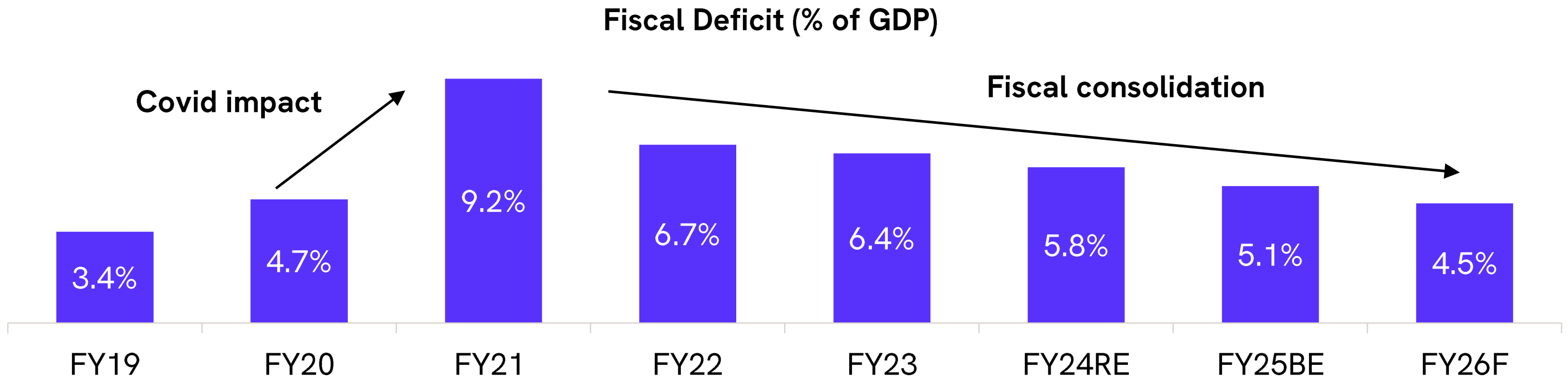
The FY25 GST compensation cess growth estimate could surpass the budget projection due to the strong performance of top-end consumption

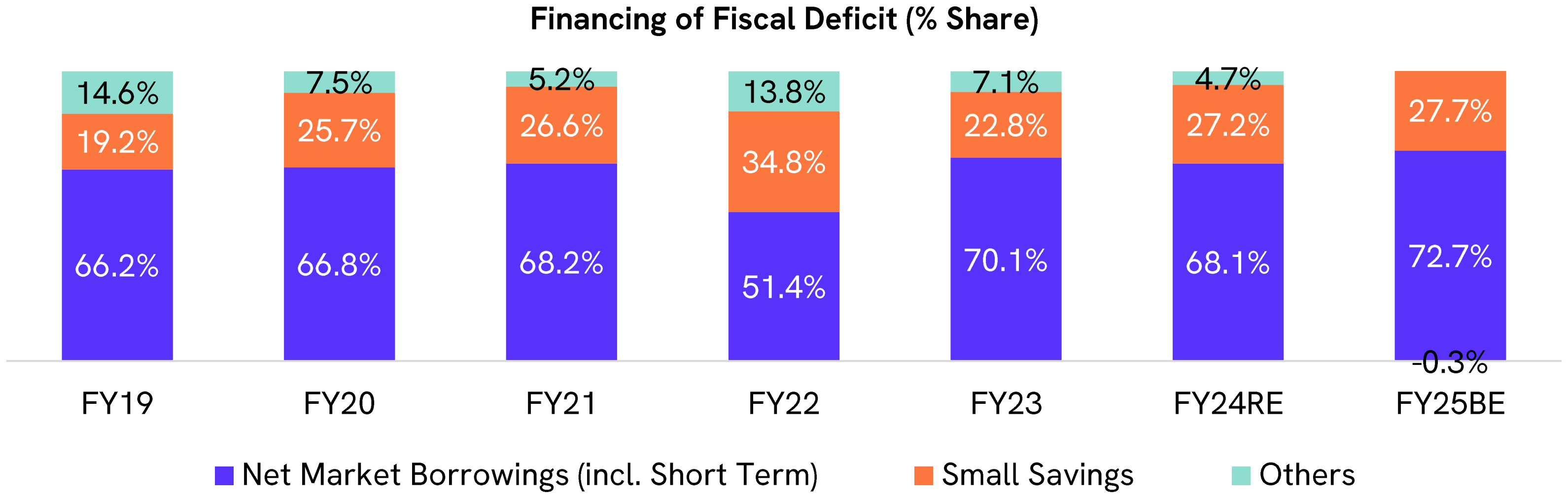
Source: CMIE, CGA, Budget Documents, 360 ONE Asset Research

Note - RE: Revised Estimates, BE: Budget Estimates

Aggressive fiscal consolidation bodes well for the debt market

Borrowings account for a 73% share in deficit financing in FY25BE, while Small Savings account for the rest





The government has set the FY24 fiscal deficit target at 5.8% of GDP, which is lower than the earlier estimate of 5.9%

The FY25 interim budget sets the fiscal deficit target at 5.1% of GDP, lower than the market expectations

The government maintains its commitment to reduce the fiscal deficit to 4.5% by FY26

The share of borrowings in financing the deficit has increased from 68% in the revised estimate for FY24 to 73% in the FY25 budget estimate

The share of small savings remains broadly flat at 28%

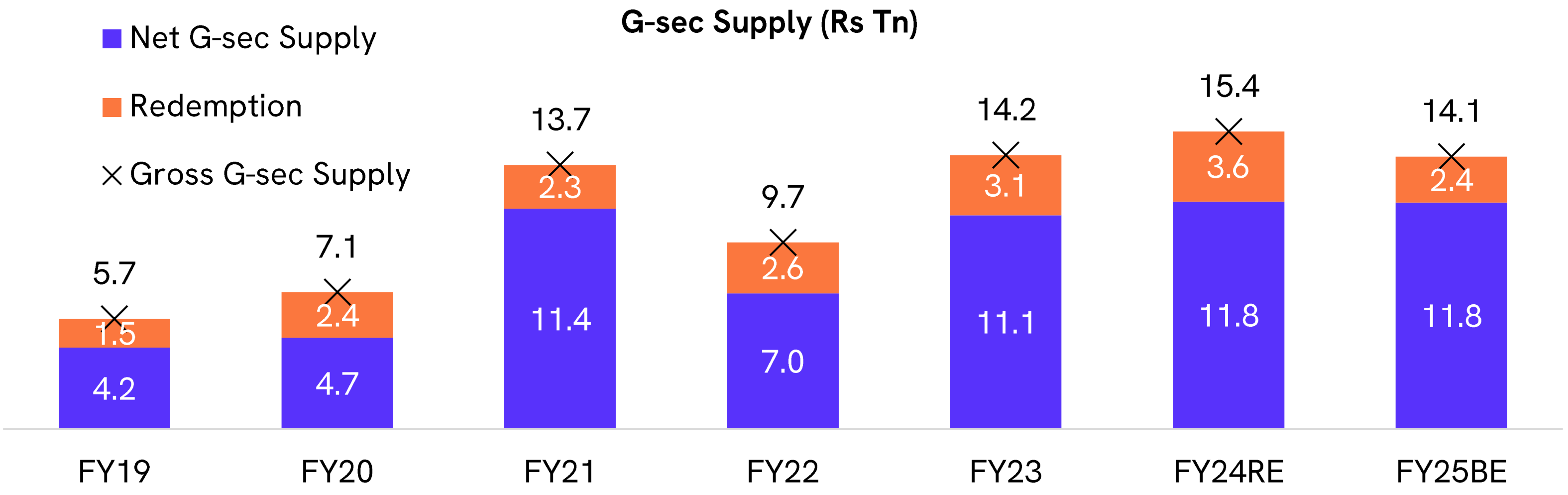
The importance of small savings in financing the deficit has substantially increased over the past decade

Source: CMIE, Budget Documents, 360 ONE Asset Research

Note - RE: Revised Estimates, BE: Budget Estimates, F: Forecast

Gross borrowings budgeted to be lower by Rs 1.3 tn in FY25

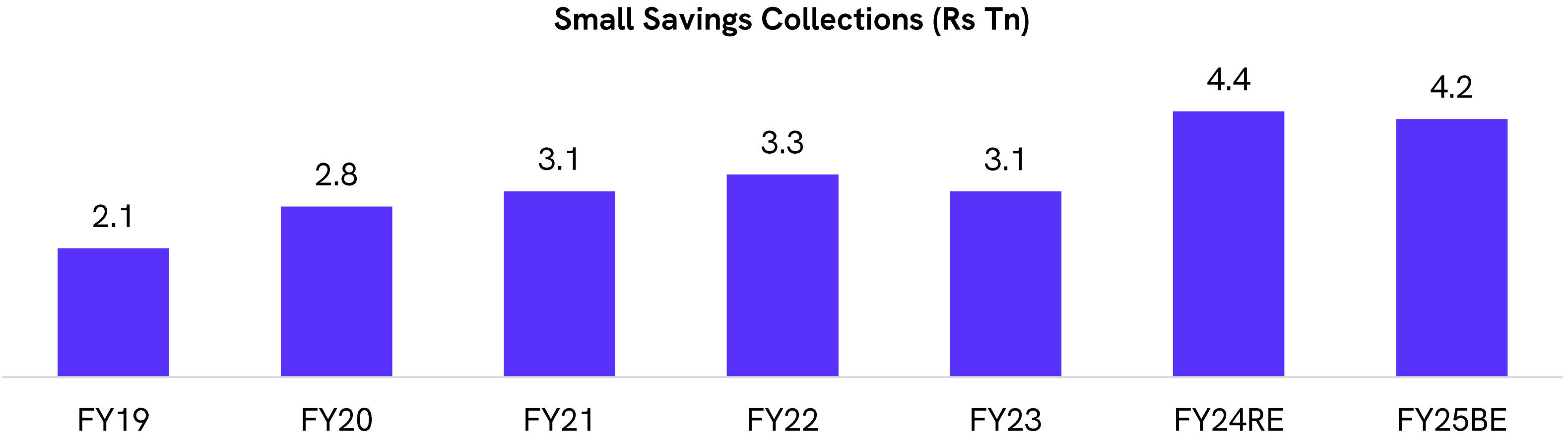
Small savings collections are budgeted to be lower than the FY24; however, actual collections could be higher



In FY25, the planned gross G-sec supply is set to drop to Rs. 14.1 tn from Rs. 15.4 tn in FY24

After adjusting for redemptions, the net supply remains unchanged at Rs. 11.8 tn

The decrease in government borrowing for FY25 is favourable for the debt market, suggesting potentially lower borrowing costs



Small savings collections are budgeted to be marginally lower in FY25

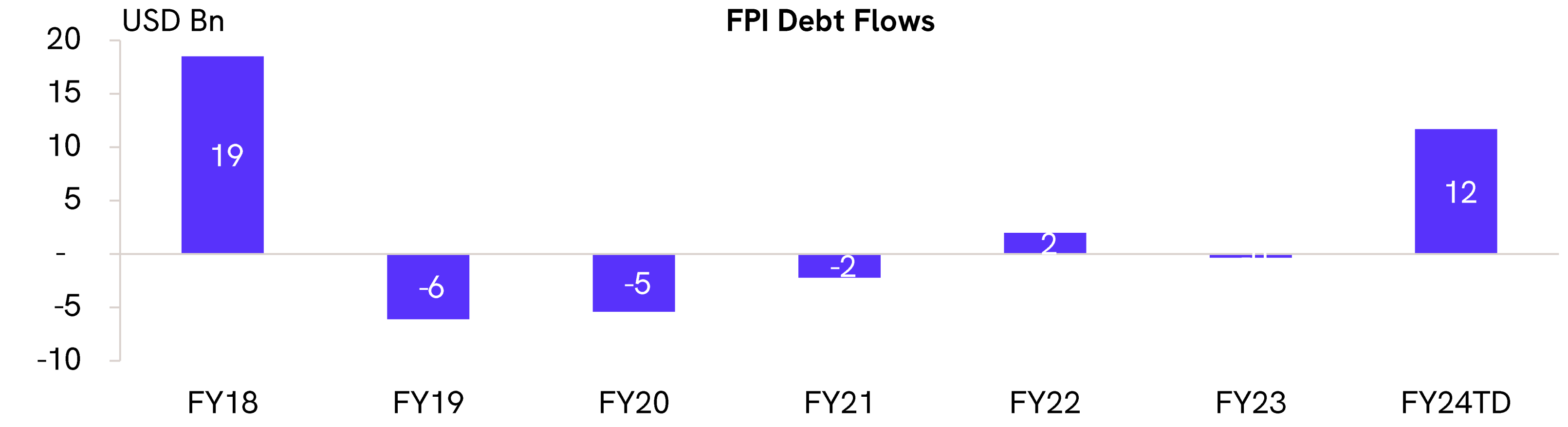
Small savings collection could exceed budget estimates, potentially reducing the government's borrowing needs in the future

Source: CMIE, Budget Documents, 360 ONE Asset Research

Note - RE: Revised Estimates, BE: Budget Estimates

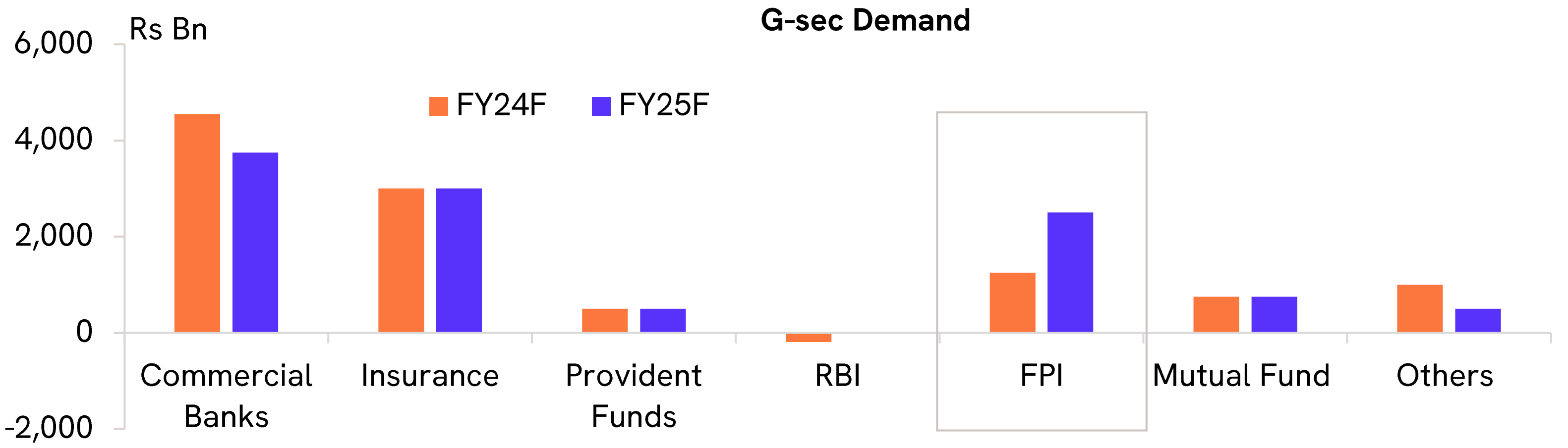
Strong FPI debt flows are expected in FY25 due to index inclusion

G-sec supply-demand outlook appears favourable with the increase in FPI demand



FPI debt flows have surged in FY24, reaching their highest level in the past five years

FPI debt flows in FY25 could be in the range of $20-30 bn on account of the inclusion of Indian government securities in JP Morgan emerging market bond index suite



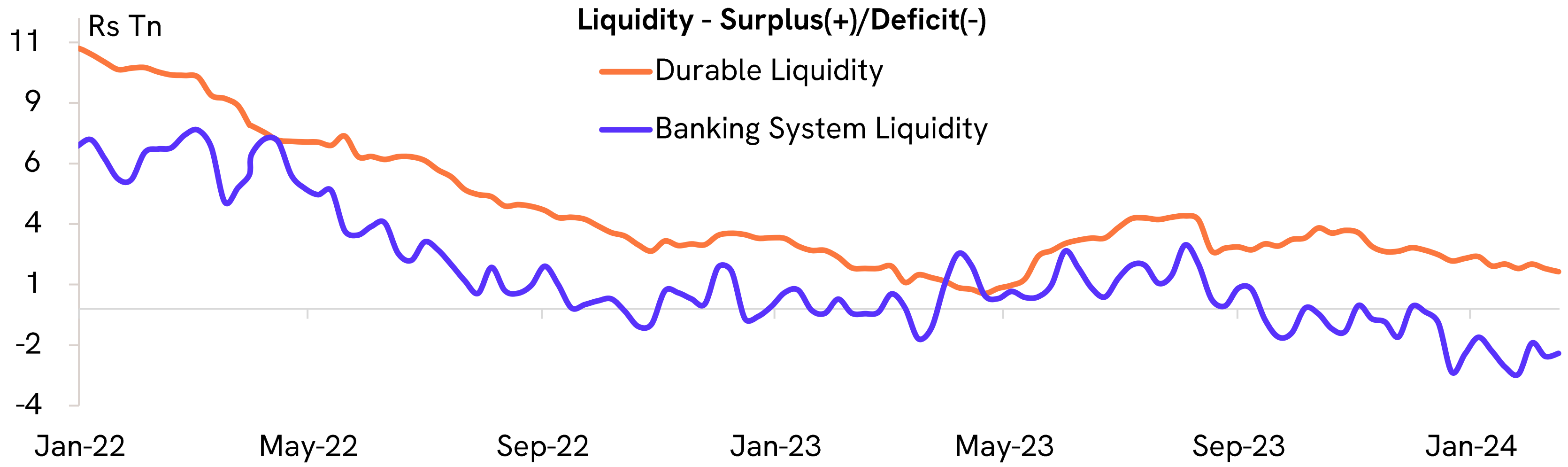
Substantially higher FPI demand, along with a decrease in gross supply, improves the overall supply-demand balance for G-secs in FY25

Source: CMIE, Nomura, NSDL, 360 ONE Asset Research

Note: F- Forecast, FYTD FPI debt flows till 22nd February 2024. 'Others' in G-sec demand include financial institutions, corporations, state governments, pension funds, etc.

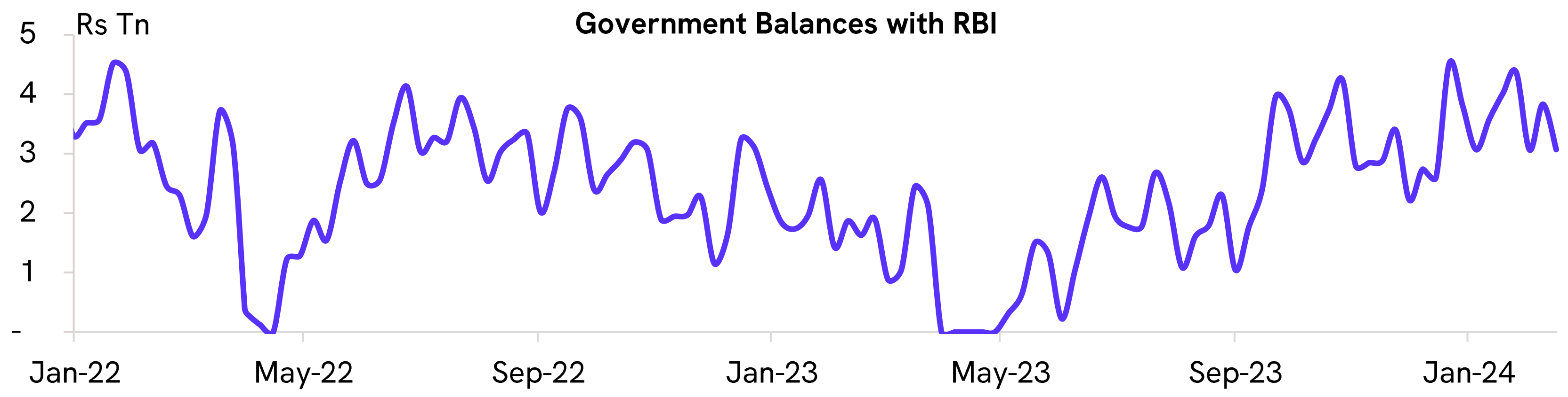
Large government balances keep banking system liquidity tight

Liquidity conditions are expected to improve as government spending picks up and cash balances are drawn down



Banking system liquidity conditions have been in deficit since September 2023, as the government has built up large cash balances with the RBI

Durable liquidity in the system (adjusted for government cash balances), however, still remains in surplus



As of February 16th, the government held ~ Rs 3 tn in balances with the RBI

A significant portion of this is anticipated to be spent by the end of this financial year

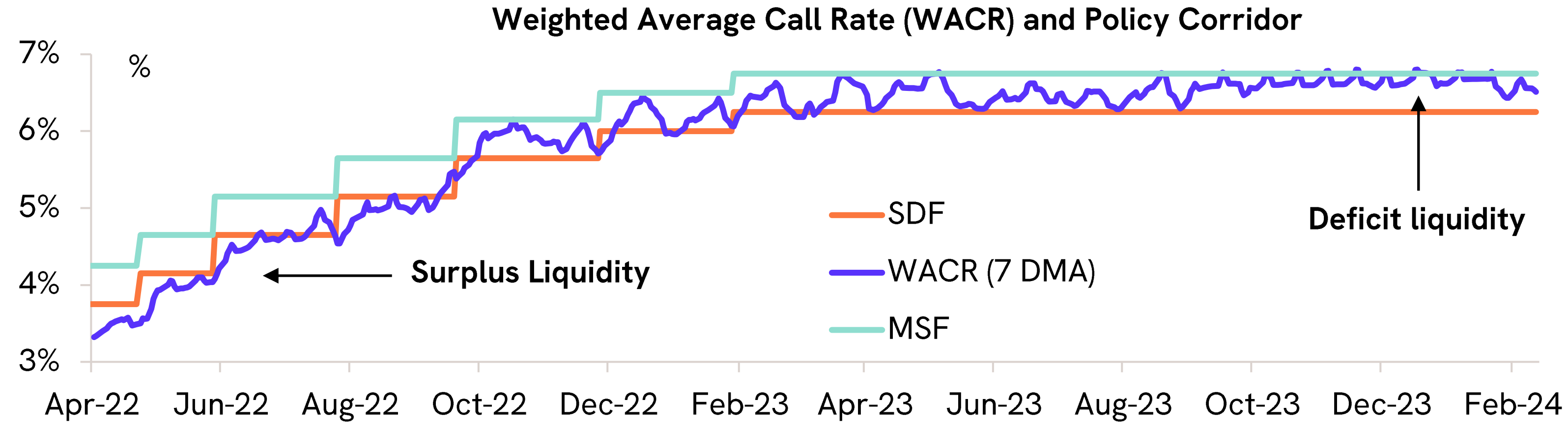
Liquidity conditions would improve as government spending picks up

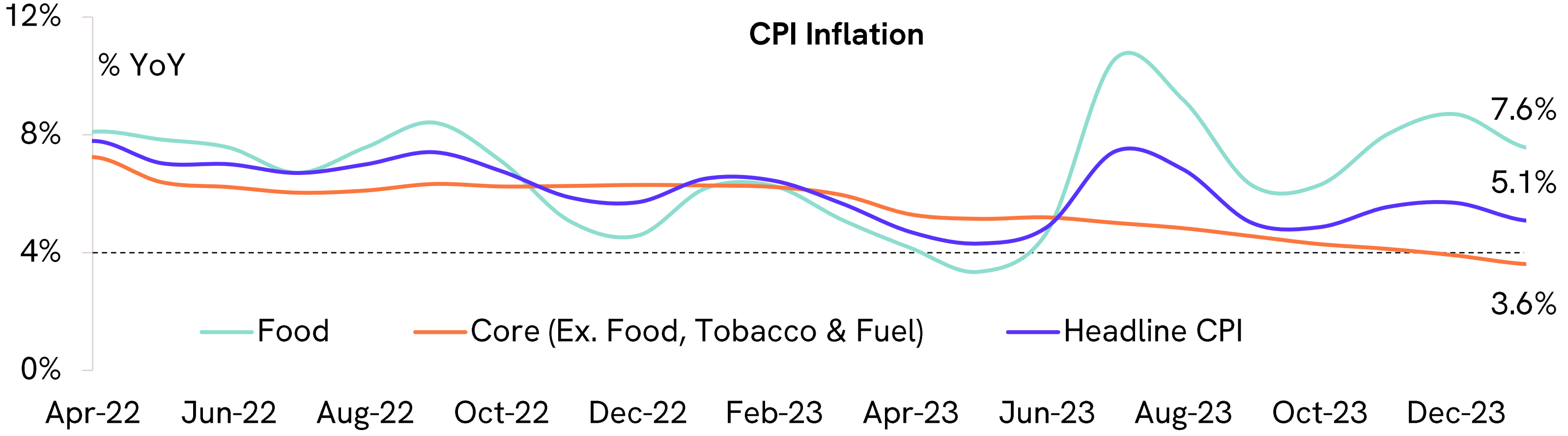
Source: CMIE, 360 ONE Asset Research

Note: Durable Liquidity = Banking System Liquidity + Government Balances with RBI + Excess CRR maintained

Short term rates should ease with improvement in liquidity conditions

Markets will also start factoring in interest rate cuts by the RBI MPC as food inflation eases





The Standing Deposit Facility (SDF) and Marginal Standing Facility (MSF) together create a policy corridor of +-25 basis points around the repo rate

The RBI's policy objective is to keep the Weighted Average Call Rate (WACR) aligned with the repo rate and within this policy corridor

Tight liquidity conditions pushed the WACR higher, nearing the MSF rate

However, the WACR is expected to decline as liquidity conditions ease

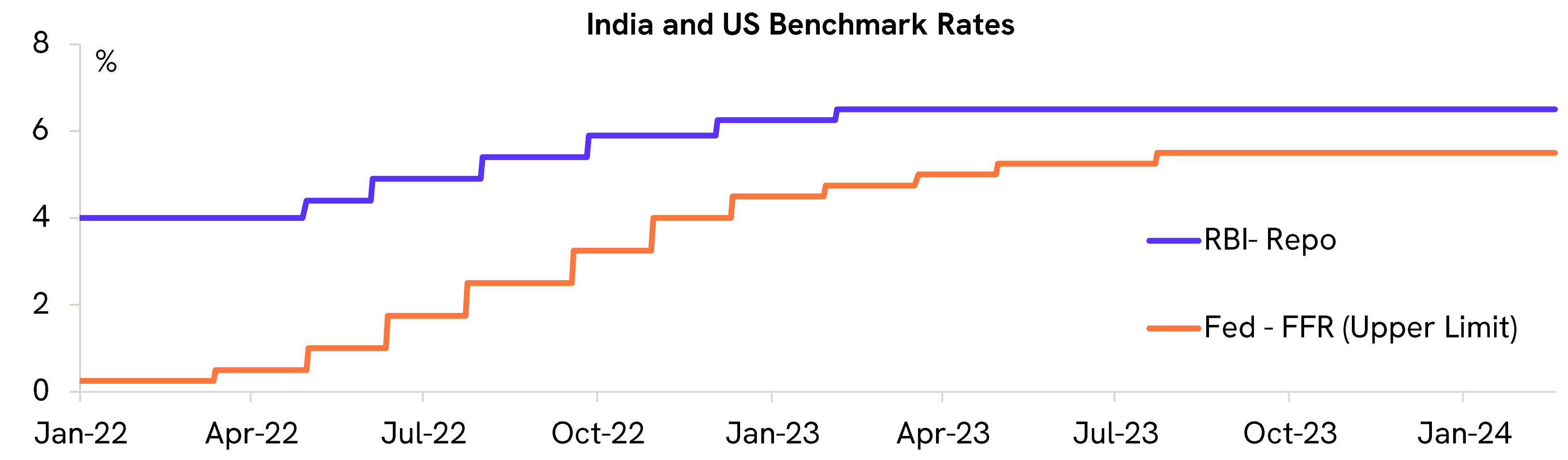
Assuming healthy rabi production and a normal monsoon, food inflation is expected to ease, thereby creating space for monetary policy easing

Short-term rates should ease as liquidity conditions improve and the RBI's rate cut cycle starts to get factored in

Source: CMIE, MOSPI, 360 ONE Asset Research

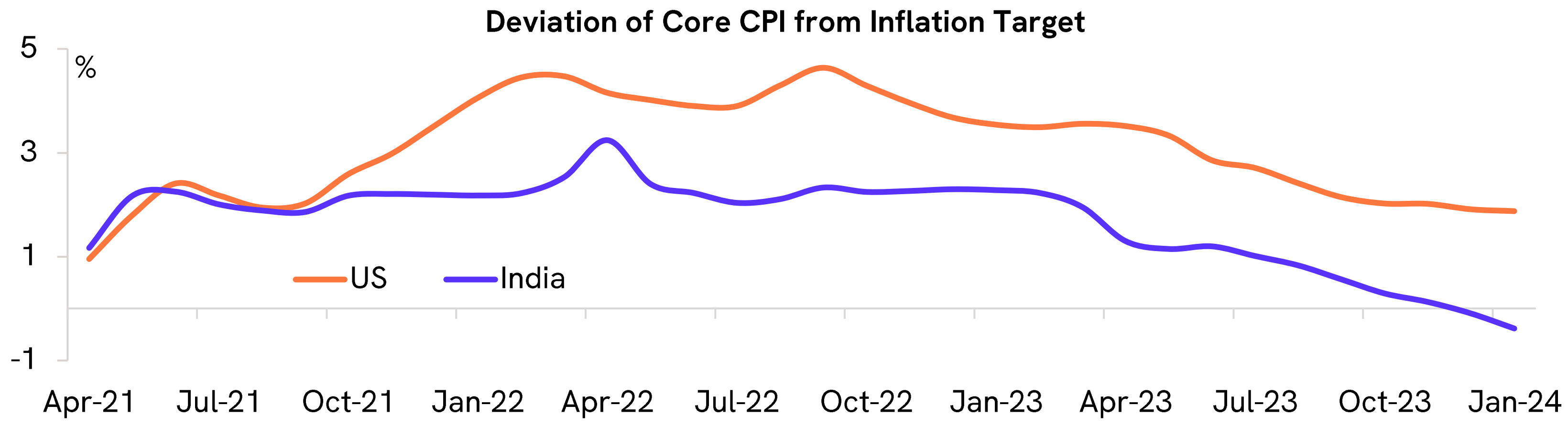
RBI could commence monetary policy easing before the Fed

The underlying inflation, as measured by core CPI, is below the target in India, while it exceeds the target in the US



The RBI has undertaken a much more modest rate hike cycle of 250 bps compared to the Fed's steeper cycle of 525 bps

Therefore, it would be inaccurate to assume that the RBI's monetary policy easing will be influenced by Fed policy



The underlying inflation, as measured by the core CPI, has fallen below the headline CPI target of 4% in India, while it continues to run higher than the 2% target in the US

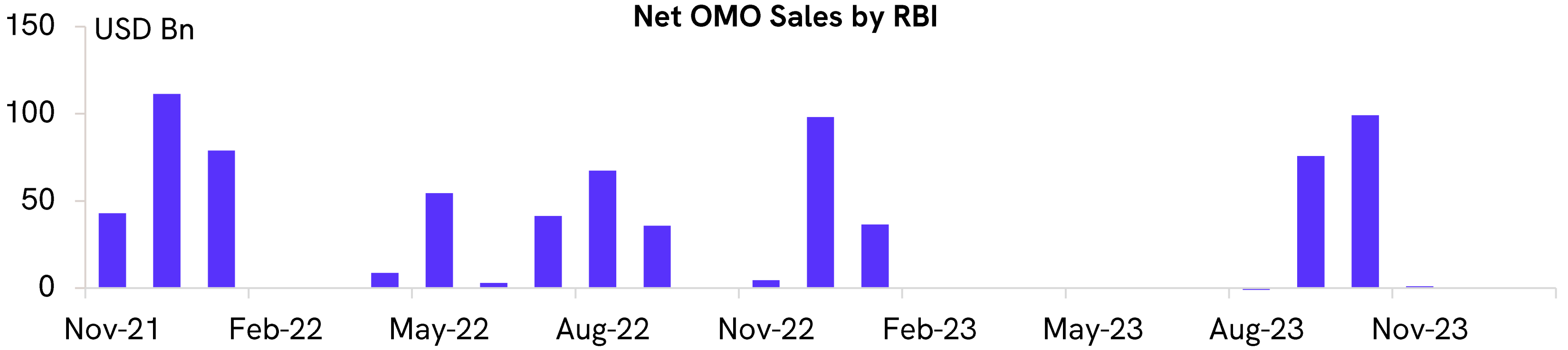
Thus, the RBI has much more room to ease monetary policy when food inflation subsides, compared to the Fed, where inflation might take longer to reach its target

Source: CMIE, FRED, 360 ONE Asset Research

Note – FFR: Federal Funds Rate

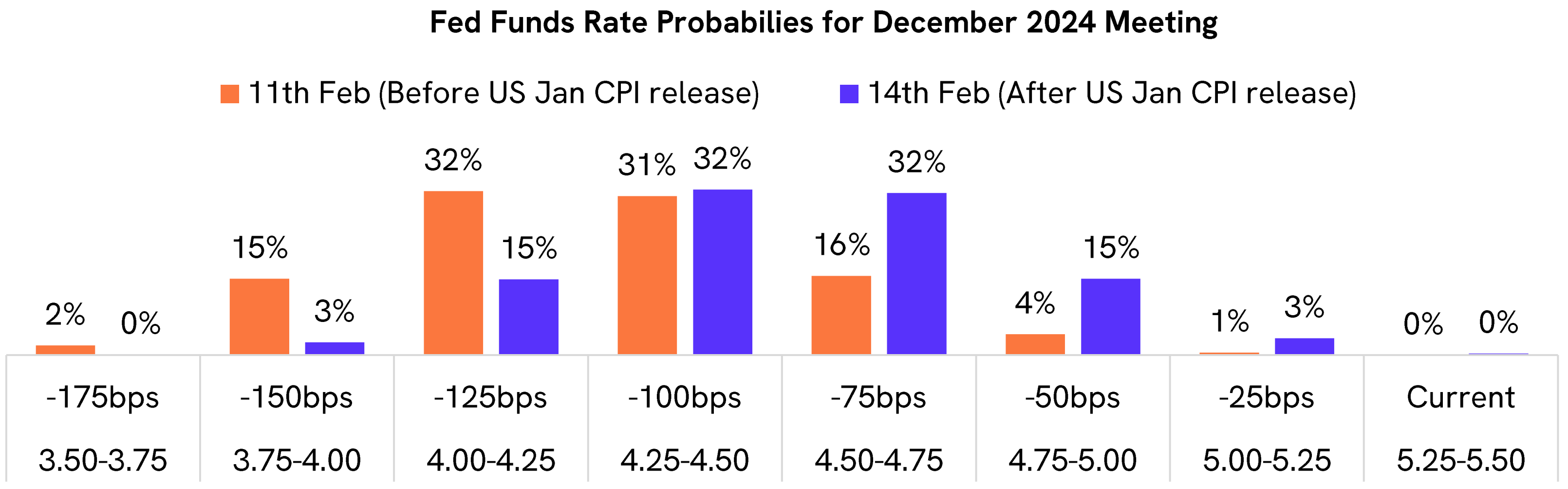
RBI could undertake OMO sales to keep liquidity close to neutral

Changing market expectations of the Fed rate cut cycle could also increase volatility in the financial markets



RBI may choose to drain excess system liquidity in FY25 through OMO sales, as already indicated during the October 2023 monetary policy

OMO sales by RBI effectively increase the G-sec supply in the market and could lead to hardening of yields



The Fed rate-cut cycle could be delayed if US inflation does not continue to moderate as expected

This could also alter market expectations regarding the timing and extent of rate cuts, introducing volatility to global interest rate markets, including India

Source: CMIE, CME FedWatch Tool, 360 ONE Asset Research

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