Economic Analysis

India FY16 Budget: A Déjà Vu for its incremental reform focus but progressively more impactful

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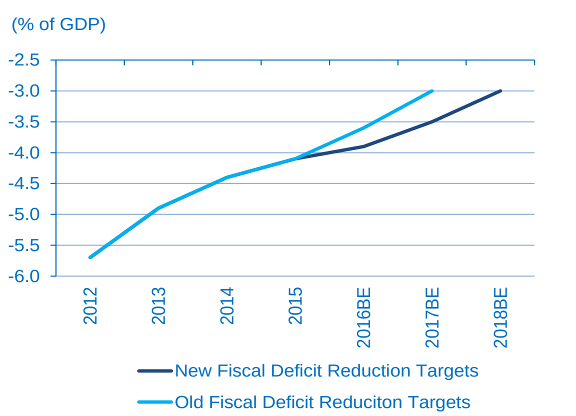
Damping high expectations of big bang reforms from India's FY16 (Year ending March 2016) Union Budget on February 28th, the Modi Government maintained its focus on incremental reforms to strengthen India's macro fundamentals. The 'several small steps' approach is a Déjà Vu by Mr. Modi, akin to his interim budget presented after taking office last May. Encouragingly however, the steps announced in the new Budget are progressively much more wide ranging, pertinent and impactful in correcting the structural deficiencies that are plaguing India's economy, particularly on the supply side. Chief amongst these are 1) raising the ante on public investments in infrastructure, 2) greater devolution to states, 3) simplification of direct tax structure and a 5 percentage point cut in corporate tax rate, 4) enhanced investment options, deferment of retrospective tax law and rationalizing legislative norms for foreign investors, 5) regulatory reforms to deepen capital markets, 6) stringent penalties and compliance policy to discourage tax evasion to help boost India's low tax-to-GDP ratio, 7) enhance scope for direct benefit transfer scheme to better target subsidies and 8) thrust on education, skill development and financial inclusion.

Near term growth imperatives hold edge over aggressive fiscal consolidation: In contrast to our expectations (*See our Pre-Budget flash*), the budget relaxed India's fiscal deficit target to -3.9% of GDP for FY16 (earlier target of -3.6%), from -4.1% in FY15. However, we believe that the let-down from a modest fiscal lift-off is largely offset by India's current imperatives of enhancing productive investments and reigniting the capex cycle. Particularly so, at a time when India finds itself in a sweet spot of lower international oil prices, which provides subsequent budgetary support through a substantial reduction in fuel subsidies and improving global growth.

Still, India can't afford to lower its guard if it has to achieve medium term fiscal consolidation targets: A close tab on revenue expenditure, effective implementation of tax reforms such as the Goods and Services Tax (GST) and divestment plans to enhance non-tax revenues is critical for the government to achieve its medium term fiscal deficit targets (- 3.5% of GDP by FY17 and -3.0% by FY18). A sharp oil price pick-up can pose a serious risk in this regard. Finally, the ensuing budget session of parliament will be important to pass critical legislative reforms related to 1) GST, 2) Coal Mines bill, 3) raising foreign investment limits in insurance and 4) Land Acquisition bill.

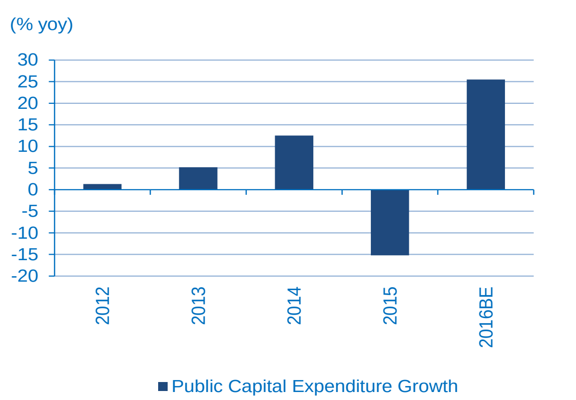
RBI unlikely to change course: Against this backdrop, we expect the Reserve Bank of India to acknowledge the government's efforts to balance growth with fiscal consolidation while keeping inflation anchored through supply side reforms. In this context, the new budget is unlikely to no change RBI's current monetary policy stance, characterized by calibrated easing in interest rates. With CPI inflation expected to fall below 5.0% in 2015, we maintain our expectations of RBI easing interest rates by a further 50 to 75 bps over rest of 2015 to aid government's efforts in boosting the capex cycle by encouraging private investments and lifting final demand.

Figure 1
India eases its fiscal consolidation targets…



*Fiscal Year; BE: Budgeted Estimates; Source: BBVA Research, GoI

Figure 2
…To lift growth through higher capital spending



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