India Budget & Economic Brief

NAB Group Economics

March 2015

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Summary & Overview

- *Finance Minister Arun Jaitley released his first full-year Budget on the 28th of February, 2015.*
- *The pace of fiscal consolidation was pushed back, with the 3% Deficit target now likely to be achieved in 2017-18. Instead, there was a strong push for infrastructure spending, increased funding for the States and a halving of fuel subsidies due to sharp decline in oil prices.*
- *Further, there were a number of positive announcements about setting up a GST by April 2016, enshrining an inflation-targeting framework for the RBI, measures to curb money-laundering and steps to monetise gold and thereby increase savings. Moreover, the Corporate Tax rate was slated to fall from 30% to 25% over 4 years, beginning April 2016.*
- *Further, measures to set up a public bank board bureau and adopt new bankruptcy laws should be favourable for the banking sector. However, the limited scale of capital infusions in the banking sector remains an issue.*
- *Overall, whilst not a groundbreaking budget, it is pragmatic and has the potential to boost India's economic well being, if properly executed.*
- *On growth, we are forecasting a 7.7% outcome in 2015, followed by a somewhat higher 8.0% in 2016, based on the newly revised GDP numbers.*
- *Following the RBI's 25bp rate cut to 7.5% on March 4, we are forecasting one more rate cut in the June quarter. This will lead to a 7.25% Repo rate by the end of 2015. Further rate cuts are possible, but are dependent on the external situation (.e.g. Fed tightening), the nature of the monsoon, supply-side improvements and progress on fiscal consolidation.*

Fiscal Deficit

- The Finance Ministry opted to slightly delay the process of **fiscal consolidation**, and instead focus on capital spending, and moving to a more federalist structure by allocating a greater share of revenue to the States.
- As a result, the **Gross Fiscal Deficit** is expected to decline from 4.1% in 2014-15 to 3% by 2017-18, a year later than previously anticipated.
- As part of a move to a **Federalist structure**, States are expected to receive a 55% increase in tax revenue relative to 2014-15.
- Further, **Capital Expenditure** in the Budget has been earmarked at INR2.4tn, a 25% increase relative to the previous financial year.
- One encouraging signal is a halving in the amount paid for **petroleum subsidies** to INR300bn due to falling oil prices. There could have been scope to further rein in other subsidy payments, such as those for fertilizer payments.
- There was a focus on eliminating **subsidy leakage** through better targeting them to the end user, using direct bank transfers and personal identity cards.
- On a final note, the Government has set a **divestment target** of INR695bn, comprising sales of minority stakes in PSUs (Public Sector units), as well as strategic share sales in PSUs.
- **Implications:** The delay in fiscal consolidation should not be a cause for concern, provided the Government is able to boost infrastructure and stick to its revised consolidation road-map. The reduction in petroleum subsidies is welcome, and could negatively impact upstream energy sector players. The divestment figure could prove a challenge, given the past record of the Government divestments has not been impressive, and the fact that some of the industries are in the metals sector, negatively impacted by weaker commodity prices.

Figure 1: Fiscal Deficit Projections

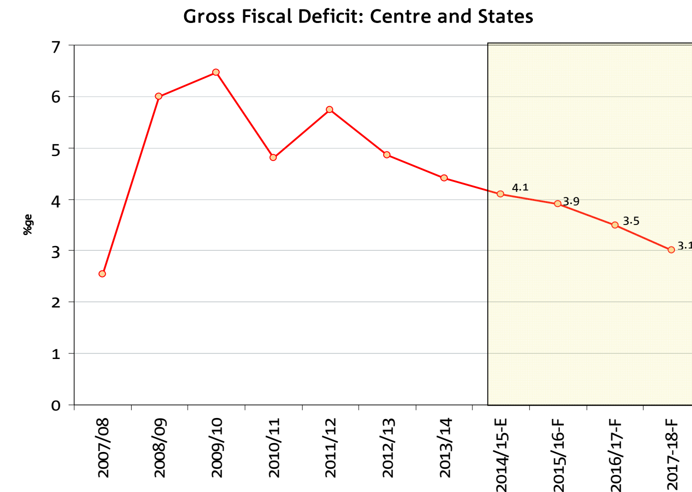
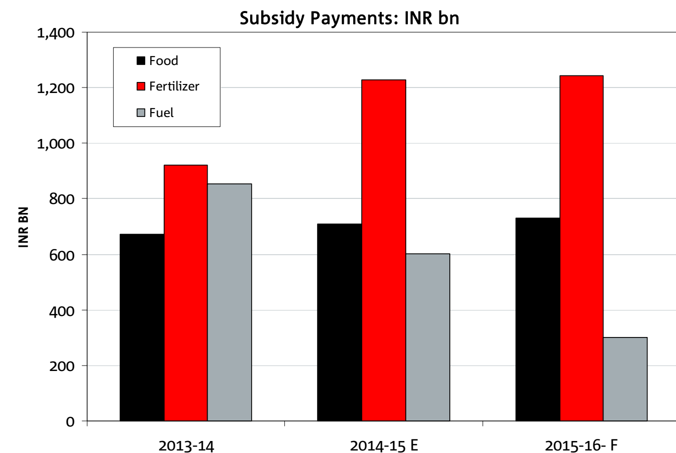


Figure 2: Subsidy Payments



Infrastructure & Manufacturing

- **Infrastructure spending** has been one of the main themes of this Budget. Recognising that the private sector might be somewhat constrained, the Government has decided to boost infrastructure spend in this Budget.
- Investment in infrastructure to go up by **INR700bn**, with a strong focus on road and rail spending.
- Setting up a *National Investment and Infrastructure* fund with an **annual inflow** of INR200bn. This would be able to raise debt and use these funds to invest in Government finance companies such as Power Finance Corporation (PFC) who can then invest in major infrastructure projects.
- Proposing **tax-free infrastructure bonds** for projects in the road, rail and irrigation sectors.
- To address deficiencies in electricity, **5 Ultra Mega Power projects** of 4,000 MW each have been proposed. These will operate through a 'plug and play' model: the projects will be auctioned to the highest bidder, but will come with prior clearances.
- **Ports** in the public sector will be encouraged to corporatise, with the aim of attracting investments and optimise their large landholdings.
- A **Self-Employment and Talent Utilization** program to support start-up businesses and promote innovation.
- An expert committee to examine the possibility of **abolishing multiple permits** with a single clearance window for projects.
- To support the '*Make in India*' campaign, tax '**pass through**' on Category 1 & 2 Alternative investment Funds will be permitted, implying that taxes will be levied on the investors, and not the funds. This will enable the funds to invest in local SMEs and start-ups. Further, local electronics and consumer durable manufacturers will benefit from lower customs duty on 22 items, many of which are used in manufacturing items such as TVs, fridges, microwaves, etc.
- Customs duty on **imported commercial vehicles** has been doubled to 20%, which will more likely benefit domestic producers.
- **Implications:** The Budgetary initiatives have the potential to kick start India's investment cycle and help tackle India's deficiencies. Companies in the infrastructure space, including those in construction and cement manufacturing should benefit. Further, those funding major infrastructure projects would also stand to gain. It is important that issues such as land acquisitions and environmental clearances due not create inordinate delays and stymie projects, as has been the case in the recent past.

Regulatory Changes

- The Finance Minister indicated a move towards a *Goods and Services Tax* (**GST**) by April,2016. If implemented successfully, this would replace a number of disparate regional taxes and generate a unified market across the country, thereby improving the Ease of Doing Business.

- Related to the above, a reduction in the **Corporate Tax rate** from 30% to 25% is proposed over4 years, commencing April 2016, along with a removal of a number of tax exemptions.

- Setting up a *National Investment and Infrastructure* fund with an **annual inflow of INR200bn**. This would be able to raise debt and use these funds to invest in Government finance companies such as Power Finance Corporation (PFC) who can then invest in major infrastructure projects.

- The **service tax rate** is expected to increase to 14% from 12.36%, as part of the move towards phasing in the GST.

- Abolition of the **wealth tax**, to be replaced by a 2% surcharge on very high income earners: above INR 10 million.

- Tax rate for royalties and fees for technical services to be reduced to 10% from 25%.

- **General Anti-avoidance rules** (GAAR) to be deferred to April, 2017 and will be applied prospectively.

- Introduction of stiff measures to deter accumulation of **black money**, including imprisonment and fines up to 300% of the value of assets, and a more comprehensive *Benami Transactions Bill* to curb black money in the real estate sector.

- A formalised move towards **inflation targeting** by the RBI (while keeping in mind growth objects). As part of the measures, the RBI will aim to achieve year ended headline CPI below 6% in January 2016, and 2-6% from 2016-17. The RBI will have to explain its position if inflation exceeds 6% in 3 consecutive quarters during the 2015-16 period. A Monetary policy committee is also expected to be set up, headed by the RBI Governor; the formation of the Committee will require an amendment to the RBI Act.

- **Implications:** These changes should improve the tax environment in the country, making it more conducive for doing business in India. The move towards an inflation-targeting should provide a more stable policy environment, and help reduce uncertainty and raise investor confidence in the Indian economy.

Financial Developments

- A comprehensive **Bankruptcy Code** to be brought in 2015-16, which will attract more firms (including overseas) to set up in India, as this will help attenuate barriers to exit.
- Establish a **Public Debt Management Office** to manage issuance of Public Debt, relieving the RBI of this duty, and potentially avoiding conflicts of interest, given the latter's monetary authority role.
- Removing different types of foreign investment caps with a **composite cap**, potentially increasing foreign investment stake in domestic private banks.
- By setting up an autonomous **Bank Board Bureau**, governance of Public Sector Banks will be greatly enhanced. On the other hand, INR79.4bn worth of capital infusion for Public Sector banks might be inadequate for their needs.
- To improve the attractiveness of (Real Estate Investment Trusts) **REITS**, and enable their take-off in India, a number of favourable measures have been adopted. Rental income of REITs from their own assets to have a pass-through facility, and rationalisation of capital gains regime for sponsors exiting at the time of listing the units of REITs.
- **Foreign Institutional Investors** are likely to maintain interest in Indian debt securities, with the withholding tax rate remaining at the concessional 5%, and not subjecting FII capital gains to the MAT (Minimum Alternate Tax) regime.
- **Long-term savings** (and therefore funds for future investment) will benefit from an additional INR50,000 tax concession for individuals who invest in the *National Pension Scheme*.
- There were a number of interesting measures to **monetise gold** announced in the Budget. These include: allowing depositors of gold to earn interest on their metals accounts, and enabling jewellers to secure loans against their metal accounts. According to research from *State Bank of India*, as much as INR 1 trillion of deposits will result from these.
- Separately, **gold sovereign bonds** are likely to be developed, wherein investors will be paid interest (~1.5-2%, according to the *Business Standard*), and be paid the amount equivalent to the gold price upon redemption. Investors can therefore earn returns on gold without any actual physical investments in gold.
- **Implications:** The Indian financial and banking architecture will likely improve from these Budgetary measures, laying a foundation for improved growth in the future. Indian debt and equity markets should be supported – other things remaining equal – as Foreign Institutional Investors will likely favour India as an attractive investment destination. Finally, the measures to monetise gold are likely to see a sharp rise in deposits, and will put investment in gold to more productive use – although participating banks could face challenges if improperly hedged.

Other Measures

- **Personal & Social Measures:** In addition to higher pension deductions (discussed earlier), there were increases in health insurance and transport deduction allowable. There were also allocations for cheap accident insurance, life insurance and special pension schemes for the poor and needy.

- **Tourism:** A visa on arrival program to visitors from 150 countries to be adopted, in stages. This will help boost international inbound tourism and support hotels and tourism providers.

- **Rural Development:** Allocation of INR 795bn for rural development.

- **Agriculture:** Aim to create a single agricultural market, and allocating INR 1trillion for different rural finance funds - improving funding allocation to the sector.

- **Education:** An estimated INR695bn has been set for the education sector, including development of highly prestigious engineering, medical and management institutes.

Financial Markets

- The Budget (and subsequent rate) have buoyed financial markets, with the *Mumbai Sensex 100* continuing to surge ahead.
- However, the strong US non-farm payrolls result, with 295K jobs added in February, raised concerns about the negative impact on impending Fed tightening on Emerging markets such as India. This caused a 2% decline in the benchmark Sensex on the 9th of March.
- Indian bond yields were last trading at 7.74%. Whilst slightly higher following the US labour market data, they are over a 100bp lower than year-ago levels. This partly reflects lower inflationary pressures, and the RBI's prudent monetary policy stance.
- The Indian Rupee has been trading around the 62-63/USD mark. According to *Bloomberg*, it has been the best performing Emerging market currency during 2015.
- A stronger rupee tends hurt importers such as oil importers, whilst exporters such as software companies benefit from a weaker rupee.

Figure 3: Equities

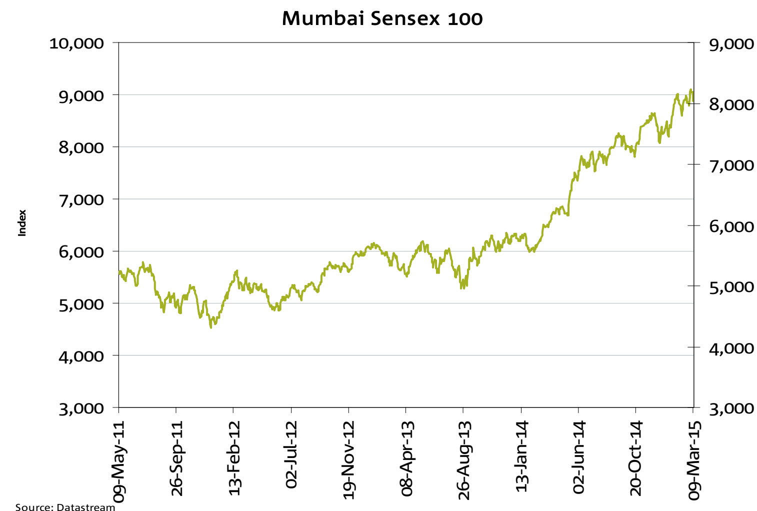
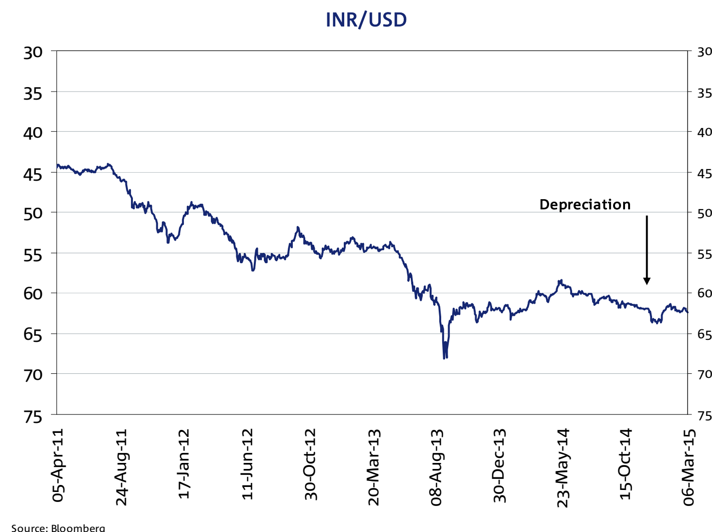


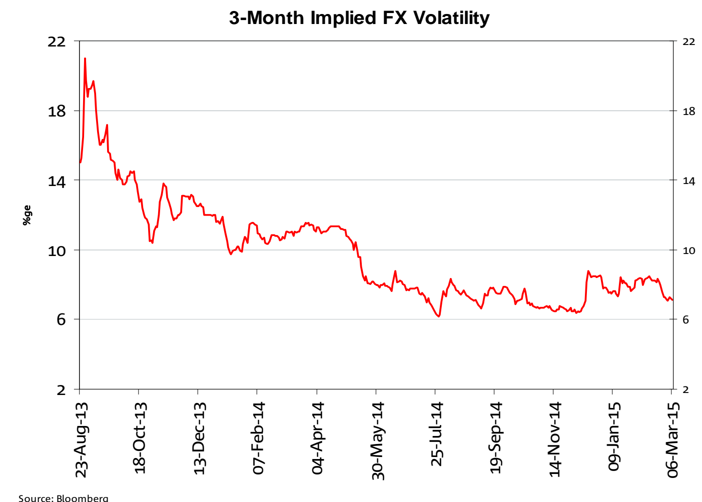
Figure 4: Exchange Rate



Sovereign Risk & Volatility

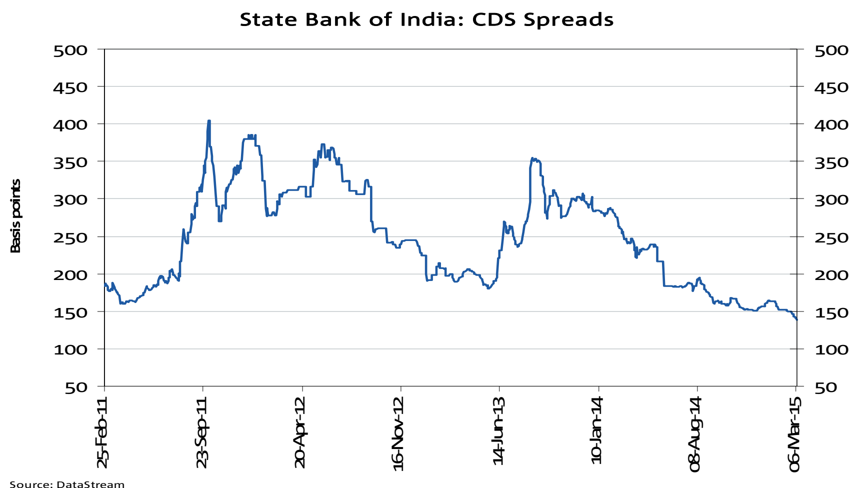
- India's volatility and risk measures continue to move in the right direction.
- External volatility, as measured by 3-month implied volatility used to price FX options, remain broadly stably.
- India's FX reserves continue to swell, and are approaching the USD335bn mark.
- According to the Chief Economic Advisor, Arvind Subramanian, a high level of FX reserves is desirable, if properly managed. He also highlighted the example of China, citing its very high reserves as a source of strength.
- We may therefore see a higher quantum of FX reserves in India, going forward.
- The Budget has also been favourable from a Sovereign Risk perspective, with State Bank of India CDS Spreads – a proxy for India Sovereign Risk – at a historical low of 140bps.

Figure 5: FX Volatility



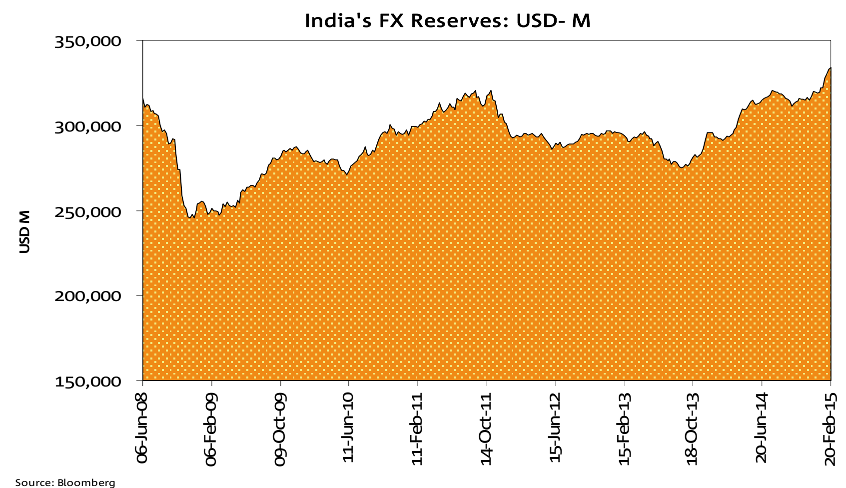
Source: Bloomberg

Figure 7: Sovereign Risk Indicator



Source: DataStream

Figure 6: FX Reserves

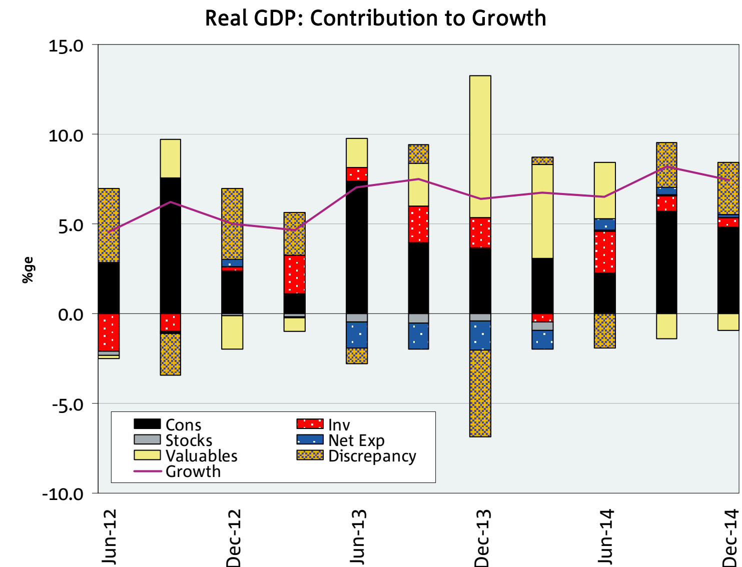


Source: Bloomberg

Growth

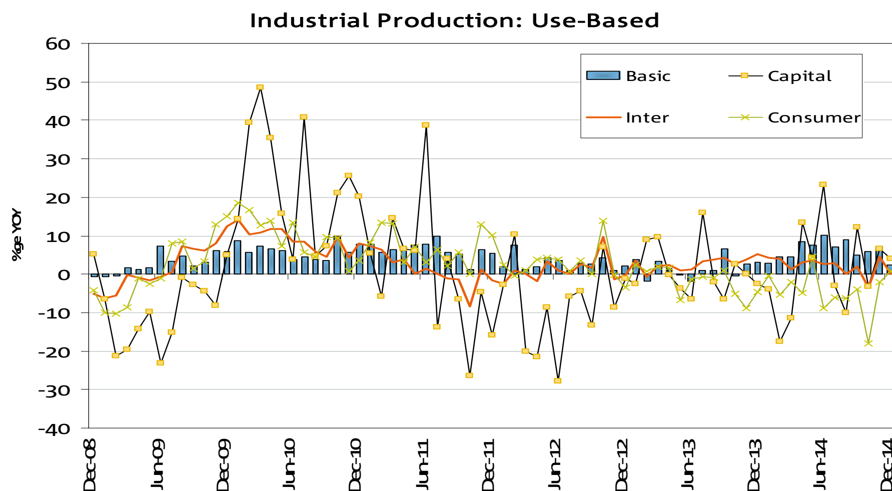
- The Indian economy expanded by 7.2% during 2014, according to the newly revised GDP estimates.
- These new estimates incorporate a number of changes: a new base year (2011-12, as opposed to 2004-05); using market prices instead of factor costs; expanded coverage of both manufacturing and services.
- These stronger numbers are not borne in other measures of activity. Industrial production rose increased by a modest 1.7% over the year to December 2014, somewhat belying the GDP numbers.
- Looking ahead, we are expecting the pace of activity to pick up, with a 7.7% expansion in 2015, rising further to 8% in 2016.
- Lower interest rates and oil prices, a pick up in the investment cycle and increase infrastructure spending and other Budgetary initiatives will help underpin activity.
- Longer-term, the successful (or otherwise) adoption of the GST will have a significant bearing on India's growth prospects.

Figure 8: GDP



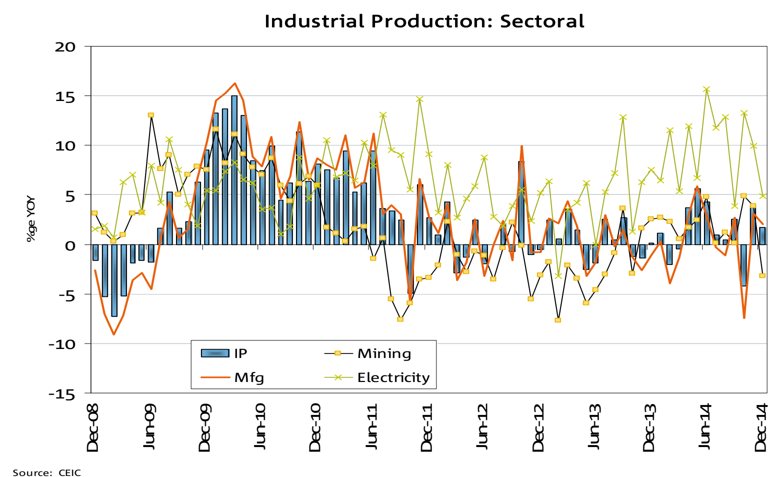
Source: CEIC

Figure 10: Industrial Production - Use



Source: CEIC

Figure 9: Industrial Production - Sector



Source: CEIC

Interest Rate Outlook

- The RBI cut the policy Repo rate by 25bp on the 4th of March. This could be viewed as a 'vote of confidence' in the Budget, including measures such as reduced subsidy and higher infrastructure spending and an inflation-targeting focus for the RBI.
- Increased transfer to the States (increasing the likelihood of a lower General Government deficit) and realistic revenue and growth projections also influenced RBI thinking.
- Moreover, the headline CPI for January, 2015 at 5.1% was modest, and set against a background of weak indicators (production, capacity utilisation and credit takeoff) and a general easing trend among Central Banks across the globe.
- The RBI highlighted that the medium term objective was to attain a 4% inflation rate by January, 2018. The target band is expected at 4%+/- 2% by then.
- Over the coming year, it indicated that inflationary pressures will remain moderate in the first half, but will firm to below 6% in the second half of the year.
- This pattern can be seen in the projection for inflationary 'base effects' chart, on the right hand side.
- NAB Economics is forecasting another 25bp cut in the Repo rate in the June quarter, following which the RBI will likely remain on hold. This implies a 7.25% Repo rate at the end of the year.
- Further rate cuts cannot be ruled out, but are dependent on a number of factors. These include: the monsoon and its impact on food prices; easing of supply constraints; quality and progress on fiscal consolidation; and finally, the external environment and possible uncertainty surrounding the expected tightening by the US Federal Reserve.

Figure 11: Inflation, CPI & WPI

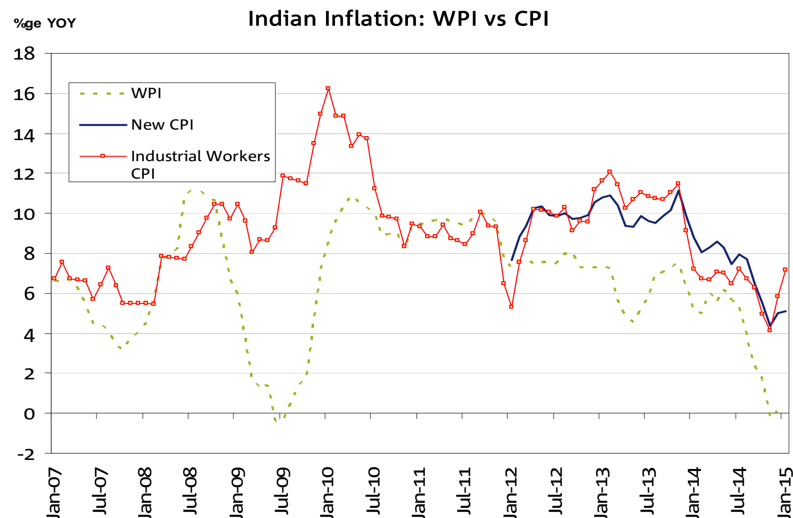
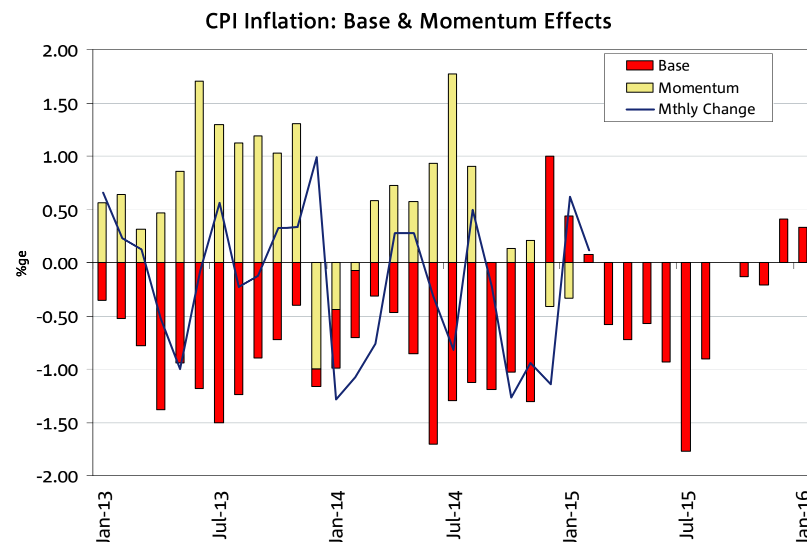


Figure 12: Base & Momentum Effects



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