Multi asset class
India Budget note

India

Populist not reformist

- **The budget disappointed and was largely populist, not reformist**
- **Fiscal deficit projection at 6.8% vs. our expectation of 7%: Risk of overshoot**
- **For equity markets, hike of minimum alternate tax to 15% from 10% a major negative**

Expectations dashed

Our view in our pre-budget note was that the probability of disappointment was significantly higher then the possibility of a pleasant surprise.

The budget has disappointed the market on many fronts, but the biggest factor was that the finance minister did not lay out a roadmap for reforms, as was widely expected.

Those of the view that the budget would encompass all sorts of exciting structural economic reforms have just had their hopes firmly dashed. Even the long-anticipated decision to increase the Foreign Direct Investment (FDI) limit in the insurance sector from 49% was avoided. Instead this was largely a populist budget focussed mainly on the poor with plenty of promises of additional infrastructure spending. According to the government, the budget will see the central government fiscal deficit hit 6.8% of GDP in 2009/10, up from the original forecast of 5.5% and last year's 6.2% outturn. This is despite revenues from the divestment programme and the sale of 3G licenses (the latter is put at INR350bn with divestments at just INR11.2bn). Our own forecast, prior to the budget, was for a 7% deficit, but the risks are now on the upside. Overall, it is perhaps not surprising that the equity, bond and foreign exchange markets all reacted badly to the budget statement.

At the outset of Finance Minister Mukherjee's speech it was made clear that the government's first challenge was to "lead growth back to 9%" and, as such, there was a need to give "further stimulus" despite "signs of revival in the domestic economy". In our view, India remains a long way from achieving this kind of growth rate on a sustained basis and will need a lot more in the way of infrastructure spending and economic reform in order to do so. History suggests we should retain some healthy scepticism as far as the former is concerned, while the latter remains firmly in the background despite (or perhaps because of) the Congress-led coalition's surprisingly decisive general election victory in May. As we argued in "Budget Preview: Easy does it" (India Watch, 26 June), the real winner of the election was not the Congress Party per se, but the left or more populist wing of Congress – a subtle but important difference. Mr. Mukherjee did suggest that it was important for the country to return to the fiscal deficit targets "at the earliest possible opportunity" and that "reforms were required" to curb the fiscal shortfall but clearly the proof of the pudding will be in the eating on this one. Our main fear is that the deficit will be controlled more by undershooting infrastructure spending targets rather than expanding the revenue base (which represents less than 9% of GDP) or cutting bureaucracy.

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On the basis of the government's forecast for extra bond issuance, it looks as though the net fiscal easing is worth in the region of 1.5% of GDP which comes on top of the previously announced stimulus plans which we estimate to be worth 2.5% of GDP in 2009/10. Government spending is expected to rise nearly 16% from last year and is 7% higher than set out in the pre-election budget of mid-February. Most of this will be devoted to extra spending on roads, irrigation and power as well as a 144% rise in spending on the rural employment guarantee scheme, an increased allocation of nearly INR40bn for urban housing and promises to give credit at "reasonable rates" to small businesses.

On the revenue side, firms will no doubt be disappointed by the fact that there were no change in corporate taxes (industry had lobbied hard for an increase in depreciation or investment allowances), while the government opted to increase the tax exemption limit for the personal sector. There was a small sop to exporters in the form of an extension of the export credit guarantee scheme, including the 2% interest rate subsidy, to March 2010, but that was about it. Overall excise, customs and service taxes were all left unchanged although the increase in import duty on gold bars and gold jewellery won't go down well with many residents!

It will be interesting to see how the Reserve Bank of India and the rating agencies respond to the budget once they have had time to digest it but our guess is that they too won't take a particularly favourable view either. It is, after all, almost certainly consistent with a rising debt/GDP ratio. As we see it, the top priority of the government is to help the poor by building a welfare state of sorts. But such an ambitious and admirable goal will ultimately need to be financed by structural tightening measures. If it isn't then it is going to become very expensive for the government to borrow money from home or abroad.

– Robert Prior-Wandesforde

Financial markets

Disinvestment – As widely expected the finance minister did not lay a roadmap for disinvestment except for some general statements. The target for this fiscal year is extremely modes at INR11.2bn (USD200mn). The economic survey had however, suggested that the government could raise up to INR250bn a year, but this found no mention.

Taxation – On balance, this was negative, while the corporate tax rate was unchanged, as we expected, hiking of minimum alternate tax (MAT) to 15% from 10% is a major negative. Some positives were that STPI has been extended for one year and that the fringe benefit tax (FBT) has been abolished. The latter is a marginal positive, considering that listed companies paid INR10.2bn in taxes. Also, securities transaction tax relief was extended only to pension trusts and for other market participants, there was no reduction in the tax. Albeit, commodities transaction tax has been abolished which is a positive. As widely expected, there was no mention of increase in exemption limit for interest paid on mortgages as was widely expected. One encouraging factor was that the government announced an initiative to simplify the direct tax code and will put a paper for public comments within 45 days.

Infrastructure and utilities

- Section 80IA extended by 1-year till FY11e for power generation, distribution, and transmission project that are getting commissioning by FY11e (earlier it was FY10e) a positive.

- Increase in the MAT rate to 15% from 10% is mixed bag. It will impact companies in the MAT bracket. Whether tax pass through is allowed or not is key. No impact on NTPC as it was not in the MAT bracket. Reliance Infrastructure and GMR are negatively impacted. However, for Reliance infrastructure UMPP's, there is a clause where any change in tax rule to be passed on.
- 23% Increase in allocation to National Highway Authority of India (NHAI) for the National Highway Development Programme (NHDP) is positive for players like IVRCL, NCC, HCC who have exposure to the NHAI projects.
- Allowing banks to access refinance from IIFCL up to 60% of the commercial bank loans to critical sector projects is positive.
- Increased allocation to the Accelerated Irrigation Benefit Programme (AIBP) of INR10bn, thereby increasing the entire spend by 87% over BE 2008-09 is positive for construction companies like IVRCL, NCC and HCC who are present in the irrigation segment.
- 87% increase in allocation towards the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) would benefit companies having exposure to urban infrastructure projects.

Banks

- No direct impact on banks. The budget fails to address any of the key reforms and issues in terms of laying down a roadmap for divestment in state owned banks or liberalization of insurance sector. In terms of indirect impact measures have been announced in agriculture and exports but the broader housing largely remains left out.
- Target for agriculture credit raised to INR3250bn for 2009/10 from INR2870bn. Interest subvention scheme for short term crop loans to farmers for loans up to INR3 lakhs per farmer at 7% per annum to continue. In addition additional subvention of 1% has been announced as an incentive for farmers who repay their short term crop loans on schedule, thereby bringing down the interest rate to 6%.Hence an additional budget provision of INR411cr has been earmarked for this.
- Time line for farmers under the Agricultural Debt waiver and Debt relief scheme extended from June 30, 2009 to December 2009. Under this scheme farmers who having more than 2 hectares of land and who have paid 75% of their dues will benefit.
- Allocation for Irrigation increased by an additional 1000cr under the Accelerated Irrigation benefit programme.
- Interest subvention of 2% on pre-shipment credit or seven export oriented sectors increased from September 2009 to march 2010

Real estate

- No major impact on the sector from the current budget.
- MAT increase to 15% from 10% will impact HDIL as it pays MAT for its Airport slum rehabilitation project. However, the intensity of impact would be lower as the company is expected to pay blended tax on both MAT and non MAT applicable projects.

Oil & Gas

- Infrastructure tax benefits (known as 80IB) has been extended to the production of natural gas. We have been already pricing this into our estimates.
- Fuel reform: There has not been any specific announcement on the subject with setting up. As expected, the subject would be dealt with an Expert Committee later. However, this is negative for Oil PSUs as market had built an expectation of some announcement in this regard.
- Increase in MAT rate to 15% from 10%: Reliance Industries has a negative impact from this announcement.

FMCG (consumer staples)

- NREG and other social sector reforms positive for FMCG demand. No hike in excise duty is positive for ITC.
- MAT increase will affect Dabur who is paying MAT now.

Autos

Direct Impact:

- Excise duty reduced by INR5,000 on cars having engine capacity exceeding 2000CC. The benefit would accrue to car models like Mahindra's Scorpio, Xylo, Bolero, Tata Motor's Safari, Sumo. However, from the point of view of earnings or sales, the amount is insignificant.
- Excise duty on petrol driven truck reduced from 20% to 8% in line with the diesel driven trucks. Non event since the fleet operator any way prefer Diesel and CNG driven trucks over petrol driven trucks due to lower operational costs.
- Due to increase in MAT, profits of Tata Motors, M&M and Ashok Leyland could be affected in FY10 due to lower profitability and R&D benefit that they claim.

Indirect Impact:

- Higher allocation under NREGS could be sentimentally positive for the rural income exposed stocks like Hero Honda.
- Higher allocation JNURM could release higher funds for replacement of buses of urban transport authorities. Thus, sentimentally positive for bus makers like Tata Motors and Ashok Leyland.

IT

- STPI tax extension by 1-year to 2011 – expands earnings of top-3 IT vendors by 4-5% and HCL Tech by c20%.
- FBT on the ESOPs has been abolished – not a material impact to the earnings (Infosys paid INR30m in FY09 on FBT on ESOPs); Even Wipro paid INR 412m as FBT last year which is c1% of the PBT.
- MAT increased to 15% from 10% – Infosys had MAT credit entitlement of INR284cr at the end of FY09, but the impact on P&L is quite small

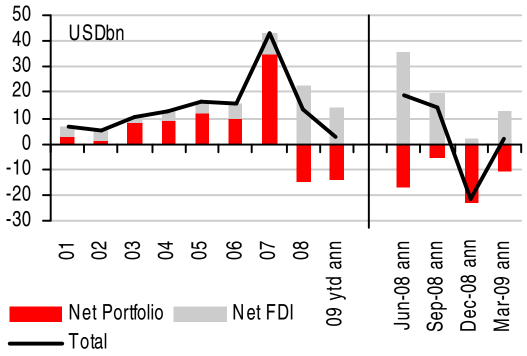
Retail – Excise on branded jewellery not affecting Titan as it did not pay this duty earlier (only if brand is inscribed in the jewellery is it payable)

FX

The budget speech could only be described as being negative for INR. Fundamentally, the biggest disappointment was the lack anticipated measures that would have boosted FDI inflows, including the raising of FDI limits and divestment of state-owned financial institutions. We have highlighted in the past the key role this component of the balance of payments has played in offsetting portfolio outflows (Chart 1), as well as funding the current account deficit, which is now re-widening on rising commodity prices.

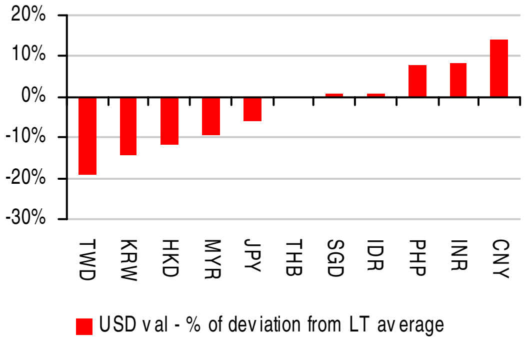
Beyond this, the lack of conviction in tackling the structural fiscal deficit implies increased pricing of sovereign risk in the medium-term, while the larger than expected fiscal funding requirement (see rates section) implies greater risk to be priced in the short-term. In our view, today's budget result injects sobering realism into post-election optimism, and sell-off in USD-INR following the polls will have proved to be a temporary nadir in broader trend higher. INR remains the only currency in Asia with an persistent outright current account funding requirement – a particularly vulnerable distinction in the current global environment – and remains one of the most expensive currencies vs the USD (Chart2). We expect USD-INR to reattempt to close the post-election gap-down in the near-term, and reiterate our target of 54 in the coming months.

Chart 1: FDI has become a key component in the capital acct



Source: CEIC

Chart 2: INR still expensive compared to Asian peers



Source: HSBC

Fixed income

Sharp Increase in GOI Issuance

The FY10 budget announcement has on balance been poorly received by the bond market given: a) the lack of a concrete medium-term fiscal consolidation programme (notwithstanding pushed-back official projections for a reduction in the fiscal deficit to 4% of GDP by FY12 and a review of the budget deficit by the Finance Commission in Oct-2009), b) significant new social spending outlays and reductions in personal income tax rates, c) modest public sector divestment receipts to plug the fiscal deficit, and d) a sharp upward revision in the FY10 fiscal deficit from 5.5% to 6.8% of GDP (FY09: 6% of GDP). The latter is equivalent to an INR884bn rise in net GOI issuance from INR3,086bn to INR3,097bn.

It should, thereby, be noted that of the INR884bn increase in net GOI issuance, INR670bn is on account of increased spending (INR400bn in plan expenditures and INR270bn in non-plan expenditures) and only INR215bn on account of lower projected revenues. In turn, this suggests scope for further fiscal slippage on account of lower nominal GDP growth (10.05% projected for FY10 versus 8% by our economist) and revenue collections, whereby our economist now projects a further rise in the fiscal deficit to 7.5% of GDP from 7% of GDP previously.

Central government funding breakdown (in INRbn)

	FY08/09	FY09/10 B	FY 09/10 R	HSBC FY10F
Central govt balance (% GDP)	-6.0%	-5.5%	-6.8%	-7.5%
LCbn	(3,265)	(3,328)	(4,010)	(4,423)
Maturing debt (LCbn)	476	540	540	540
Of which: Domestic	440	540	540	540
Of which: External	36	n/a	n/a	n/a
Gross Funding Needs	3741	3868	4550	4963
Gross GOI Issuance (LCbn)	3,060	3,626	4,519	4,519
GOI redemptions	440	540	540	540
Net GOI issuance	2,620	3,086	3,979	3,979
Other Domestic funding	671	190	205	205
Unaccounted (budget overrun)				413
External Funding	n/a	96	160	160

Source: HSBC, MOF

Overweight recommendation reduced to marketweight

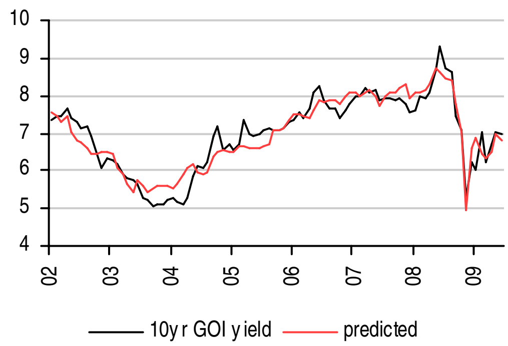
The key message from the budget announcement is therefore one of further fiscal slippage, which is significantly in excess of market expectations and prior official announcements. In combination with prospects for a pick-up in economic growth during H2 FY10 and a return to positive WPI inflation, economic fundamentals are clearly negative for the GOI bond market.

However, one key variable to watch is to what extent the RBI will continue to accommodate the sharp increase in central – and state – government borrowings through the provision of ample liquidity and continued low reverse repo and CRR rates. Already, ample bank liquidity due to surplus money market liquidity (INR1279bn pre-budget, augmented by a special INR597bn RBI repo) and falling bank loan-deposit ratios (deposit growth of +22.5% y/y versus 17.4% y/y bank lending growth as of April 2009) has fuelled increased bank appetite for GOI bonds. Crowding-out effects may, thereby, keep private demand for capital – and hence bank lending growth – subdued.

In this respect, our 10yr GOI yield regression model (R-squared: 0.8728) suggests that bank liquidity and the RBI's reverse repo and CRR ratios are the main determinants for the level of 10yr GOI yield followed by the size of the fiscal deficit. Our regression model now suggests a fair value range for the 10yr GOI yield between 4.85-6.57% (based on a 95% confidence interval) and 4.60-6.84% (based on a 99% confidence interval). This incorporates HSBC's house-view for a further increase in the fiscal deficit to 7.5% of GDP fiscal deficit (equivalent to an INR4,423bn fiscal deficit) for INR413bn in additional issuance than currently budgeted.

Therefore, unless we see evidence that the RBI will change its accommodative policy stance or for bank lending growth to pick up sharply, we believe that today's budget announcement will primarily result in a one-off jump in GOI yields (and the 5yr INR OIS rate), rather than a steady rise in GOI yields. In this respect, we now raise our target entry-yield for the 10yr GOI yield from 6.50-6.75% to 7-7.25% to take into account the possibility of increased front-loading of GOI issuance and now recommend a marketweight position to the GOI market until these levels are reached.

10yr GOI yield versus HSBC regression model



Source: HSBC

Likewise, in terms of portfolio positioning, a short portfolio duration position – centred on the 3-5yr curve area – is warranted, though we recommend receiving 1yr INR OIS on any upmoves and 5yr INR OIS around 6.5% respectively given prospects for continued flush money market liquidity near-term. Our economist, in this respect, expects the RBI to only tighten its policy stance by Q1 FY11 (April-June 2010).

Disclosure appendix

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