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EYE ON THE ELECTIONS?

An Aranca Report on India's Interim Budget 2014

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INTERIM BUDGET 2014

PASSING THE BATON

The Finance Minister P. Chidambaram faced a dilemma as he rose to present his budget proposals on 17th February. Since this was a vote on account rather than the budget, his terms of reference were restricted constitutionally, and there was very little scope for him to introduce new taxation and expenditure proposals. In addition, the poor state of the economy has affected government finances and his financial maneuverability.

In the last budget of the UPA II government, Mr. Chidambaram stressed on the country's inherent potential to regain high economic growth. While certainly doable, recovering from the sharp drop in economic growth and stemming the high inflation seen in the past few years would prove an uphill task for the next government. With the general elections now only months away, clearly some of the targets set in the interim budget appear optimistic.

Fiscal prudence and economic growth recovery was the expected undertone going into the budget, but the targets may find few takers. Reducing the current fiscal deficit by 50bps (4.1% of GDP in FY14/15 from 4.6% in FY13/14) would mean a balance between growth in collections and reduction in expenditure. Furthermore, a nominal GDP growth rate target of 13.4% for the coming fiscal year implies a real GDP growth rate of above 6% and inflation easing below 6%. When you consider current levels, these are tall expectations.

The inconsistent math does not end here. The government's target of tax buoyancy at 1.5% for FY15 is again aggressive after achieving a likely sub-1% in FY14. To add to this, the quality of the projected fiscal consolidation appears to be deteriorating. The contribution of revenue deficit (at 3.3% of GDP) is expected to go up by 100bps to 72.5% in FY15, which is never a sign of systemic and logical fiscal prudence.

Sops for the middle class

Having said this, there are several sops in the interim budget aimed at appeasing a large section of the electorate with the upcoming elections in mind:

a. The excise duty on two-wheelers and small cars has been reduced; this is likely to bring down prices in the low to mid-segment of the automotive sector.

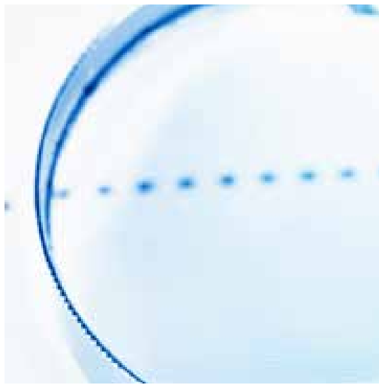
b. The Finance Minister has maintained the fertilizer subsidy for the farm sector even as the farm loan subvention scheme continues to run.

c. A cut in excise duty on capital goods and consumer durables sector is likely to bring down prices of ACs, toasters, ovens, transformers, switch gears, etc.

The Finance Minister proposed certain indirect tax measures to promote domestic manufacturing in sectors such as mobile handsets, soaps, chemicals, road

construction and currency-specific security paper manufacturing. Furthermore, he had a positive word for the bond market. Gross market borrowings for FY15 are expected to total around INR6.0 trillion compared to INR5.6 trillion in FY14. This is likely to bode well for yields in the short term.

Overall, the interim budget leaves a lot to be desired, although it was unlikely that any major structural changes would be proposed. The tone of the budget was one that highlights the pressure of the upcoming general elections as well as the depth of the fiscal inefficiencies that need to be rectified. Clearly, with regard to tougher initiatives such as the Goods and Services Tax and the Direct Tax Code, UPA II appears to have passed the baton to the forthcoming government.



INTERIM BUDGET 2014

IS THE ARITHMETIC ADDING UP?

The Finance Minister had to execute a careful balancing act which would appease the domestic electorate as well as foreign investors and rating agencies by following the principles of fiscal prudence and sustainability. Mr. P Chidambaram primarily focused on short-term goals, promising that “we (the Congress party) shall never do anything that will affect the stability of the foundation of India’s economy.”

To begin with, the Finance Minister is projecting a real growth rate of 6% for 2014–15, marginally higher than the RBI and IMF estimates of ~5.5%. However, there are risks to these forecasts as the Indian economy is at the lower end of the recovery curve, stymied by infrastructure constraints and difficulties in doing business. These problems are structural in nature and are unlikely to be resolved in the short term. Furthermore, the possibility of international shocks transmitting through the economy (in the form of rising oil prices) and driving down growth cannot be discounted, given India’s high dependence on imported hydrocarbons.

Risks to this growth forecast will also be alleviated by the reduced outlay on capital expenditure. Capital expenditure (used for creation of physical assets) for 2014–15 is down 6.9% from that budgeted for 2013–14. In contrast, revenue expenditure (salaries and other running expenses) is up 7.9%. Moreover, the outlay on plan expenditure (productive expenditure), at INR55tr, is the same compared to last year. The strategy of committing funds to meet expeditious short-term goals will be a concern for the next government.

Delving deeper into the budget estimates, the taxation proposals are a cause for concern. Total growth in gross tax receipts for 2014–15 is estimated at 19%. At face value, this number may sound reasonable. However, there has been a 6.3% decline in the 2013-14 budgeted gross tax receipts and the actuals that were presented by the Finance Minister. In addition, India is recovering gradually from its economic slump, and it would be very difficult for the government to realize greater revenues on the assumption of rapid tax buoyancy aided by a possible economic recovery.

With regard to the fiscal deficit figures, the Finance Minister stuck to his promise of not crossing the “red line” with a fiscal deficit estimate of 4.6%. However, despite best efforts, these estimates will have to be achieved at the cost of reduced capital expenditure and rollover of subsidies. As discussed earlier, capital expenditure in the budget had to be compromised to meet short-term targets pertaining to subsidies and revenue expenditure.

The quantum and impact of subsidies has not been factored fully by the finance ministry. Budget estimates put total subsidies for 2014–15 at INR2.5 trillion, a marginal increase over 2013–14. However, this is assuming that the minimum support prices for food grain will not be raised and oil and fertilizer prices would

not increase (which is unlikely given the pricing pressure on these commodities). The budget also rolls over INR3.5 trillion in unpaid fuel subsidies to the next financial year. Furthermore, the Finance Minister has budgeted for flat growth in borrowings (INR52tr) assuming a 6% plus economic growth, which looks unlikely given the current challenges faced by the economy.

Another troubling fact is that the revenue deficit estimate of 3.3% has not changed from 2013-14. Thus, while the fiscal deficit is expected to decrease, revenue deficit would fall only marginally. This implies that the government made little effort to drive up revenue and expects the majority of the adjustment to occur at the expenditure end (mainly plan and capital expenditure).

In addition to these proposals, which are likely to have a short-term impact, there are others that could have serious repercussions in the short to medium term. These include the rollover of oil subsidies to the next fiscal year (INR3.5tr), announcement of the Seventh Pay Commission, maturity of government debt securities worth INR15–25 trillion annually over the coming five years, and expansion of cylinder subsidies.

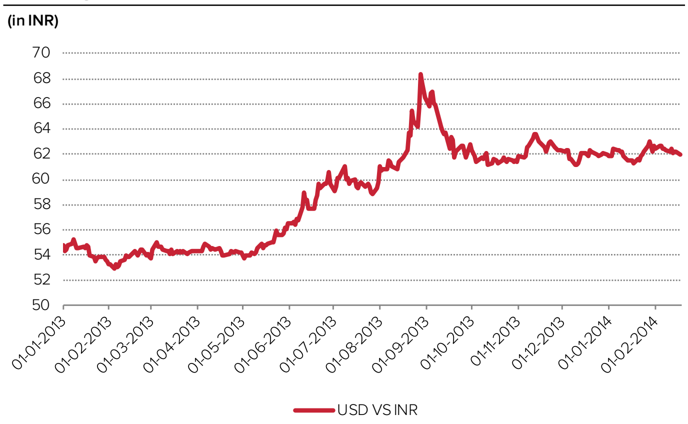
In sum, given the precarious state of government finances and the poor state of the economy, Mr. Chidambaram tried to execute a pragmatic budget, which would address both short-term concerns and lay foundations for long-term growth. However, despite his best intentions, the budget proposals will be tied to a number of fragile external conditions (such as the economic growth in developed countries as well as rising crude prices) which could unravel fast and affect the budget proposals specifically and the country at large.

INTERIM BUDGET 2014

EXTERNAL SECTOR: PRESSURE ON RUPEE TO REMAIN?

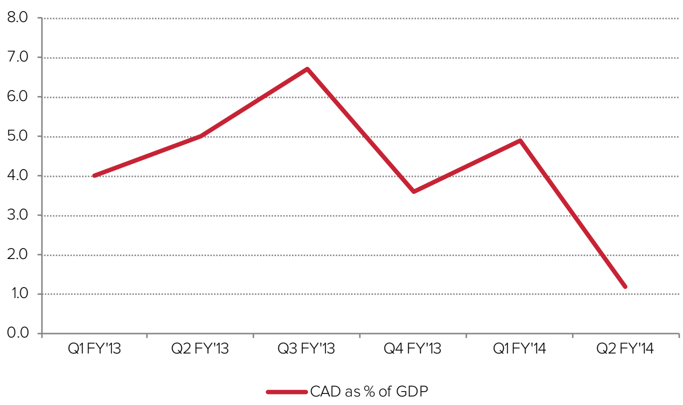
India has been consistently running a high current account deficit, which led to the rupee depreciating to ~INR68 in August 2013, down 18% year-on-year. However, since Q3 CY13, the exchange rate has been more or less stable after RBI Governor Raghuram Rajan took over. This is due to the shrinking of current account deficit, which fell to 1.2% of GDP in Q2 FY14 from 5.0% in the corresponding period of the last fiscal year.

Exchange Rate: Rupee VS Dollar



Source: RBI

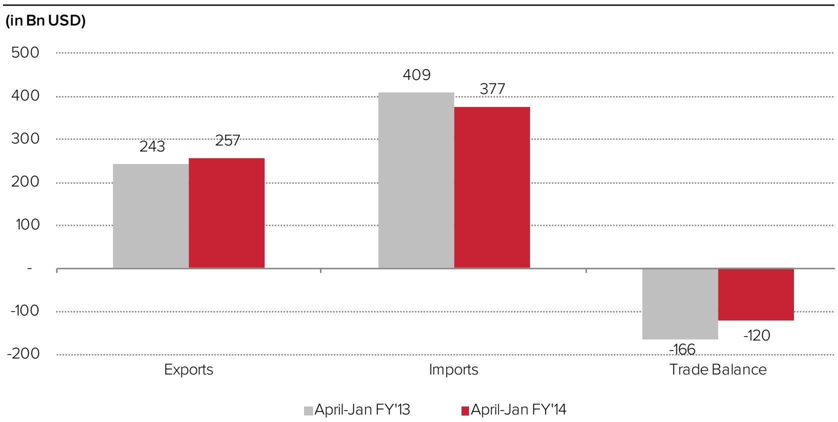
Current Account Deficit: As % of GDP



Source: RBI

Current account deficit decreased due to an up tick in global trade and slowdown in imports. Due to the rise in global trade, merchandise exports from India increased. Imports decelerated primarily due to a reduction in gold imports following an increase in customs duty by the government. This helped shrink the trade deficit to an estimated USD120 billion for April–January 2013–14 compared to USD166 billion in the corresponding period the previous fiscal year.

India's Trade Deficit



Source: RBI

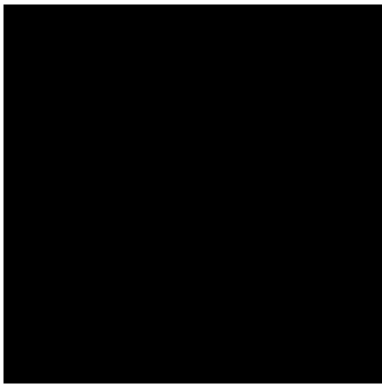
In its interim budget, the government plans to contain the current account deficit at USD45 billion in FY14 as against USD88 billion last fiscal which was all-time high. To achieve this, it has:

- Increased the customs duty and curbs on gold import by RBI; and
- Offered concessional dollar-swaps for lenders to spur capital inflows.

Due to the curbs, imports declined at the highest rate in four months in January, down 18.07% to USD36.6 billion, driven by a 77% fall in bullion imports; consequently, the trade deficit narrowed to USD9.92 billion in January from USD10.14 billion in December. On the other hand, exports rose 3.8% in January (3.5% in December) due to depreciation of the rupee and recovery in Western economies. This was the third consecutive month-on-month increase. Exports have increased 5.7% Fiscal-Year-To-Date(FYTD) to USD257 billion in 2014 over that the same period a year earlier.

This is expected to offset the negative impact of a potential jump in imports next year, resulting in continued low levels of CAD. Analysts expect the outlook for current account deficit to be positive for FY15 and estimate it to be in the range of 2.5–3% of GDP.

Global uncertainties may result in capital outflows that may again take the current account deficit to higher levels, thus exerting downward pressure on the rupee. Thus, strong capital inflows in the form of FDI and FII are necessary to keep a check on India's current account deficit. In the wake of this, the government's liberalization policy to attract larger investments in telecommunication, pharmaceuticals, civil aviation, power trading exchanges and multi-brand retail is immensely important. Markets seem to have priced the potential US Fed tapering and gradual end of the quantitative easing; hence, the rupee did not fluctuate much in recent months.



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SECTORAL IMPACT

AUTOMOTIVE

EXPECTATION: Despite the precarious fiscal deficit, some announcement was expected as the sector has slowed significantly. Domestic passenger and commercial vehicle volumes declined 6% and 20% FYTD, respectively, in FY14.

BUDGET PROPOSALS: The excise duty on two-wheelers and small cars has been reduced from 12% to 8%, while that on cars with engine capacity less than 1500cc has been decreased from 24% to 20%. On vehicles with capacity exceeding 1500cc, the excise duty has been lowered by three percentage points to 24%. On SUVs, the excise duty has been decreased to 24% from 30%.

IMPACT: This would lead to a reduction in prices of vehicles, a big positive for manufacturers as well as consumers.

AGRICULTURE

EXPECTATION:
Some announcement was expected to relieve pressure on the farm sector. A good monsoon this season may help the sector further.

BUDGET PROPOSALS:
The budgeted fertilizer subsidy for FY15 stands at INR679bn, while that for FY14 has been revised from INR659billion to INR679billion. The agricultural credit target has been increased to INR8,000bn, whereas the farm loan interest subvention scheme would continue to run.

IMPACT: Due to the shortage of funds, subsidy totaling INR300billion would be rolled over to FY15; hence, the impact is expected to be limited. Furthermore, considering the expected rise in gas prices from FY15, the subsidy on urea has been increased from INR265billion for FY14 to INR310billion for FY15. Increased credit is expected to boost production, easing food inflation to some extent; however, it would also impact the consumption of agricultural feedstock such as fertilizers, seeds and chemicals. Farms will get credit at low rates (4% per annum) if they pay on time, which bodes well for the sector.

CONSUMER DURABLES

EXPECTATION: The manufacturing sector has contracted 0.2% FYTD in FY14 (+1.1% in FY13), while the April–December 2013 IIP numbers for capital goods came in at -0.5%. Consumer durables production fell 16.2% in December 2013, the 13th straight month of decline. Some positive measures were anticipated to turn the fortunes of the sector, which has also impacted the banking sector adversely.

BUDGET PROPOSALS: The excise duty has been cut to 10% from 12% for capital goods such as transformers and switchgears, and certain consumer durables like ACs, toasters and ovens. The earlier duty exemption on imported construction machinery has been withdrawn. The defense budget for FY15 has been increased by 10%. Also, the Finance Minister announced four ultra-mega solar power projects with a capacity of over 500MW for FY15.

IMPACT: Prices of consumer durables under Chapter 84/85 would be reduced; this is expected to boost demand. The withdrawal of exemption on imported machinery is likely to support domestic production, while defense suppliers stand to benefit from a higher budget allocation. The announcement of projects is a big positive for equipment providers and ancillaries in the solar power sector.

OIL AND GAS

EXPECTATION: The government is progressively reducing the oil subsidy and some announcement was expected in this year's budget as well.

BUDGET PROPOSALS: Oil subsidy has been slashed from INR854.8billion for FY14 to INR634.3billion for FY15. This figure includes INR350billion postponed from the current year.

IMPACT: Given the inclusion of FY14's INR350billion subsidy in the figure for FY15, the reduction is huge. The next Finance Minister may roll back some of it.

BFSI

BUDGET PROPOSALS: The farm loan interest subvention scheme will be continued, while there will be capital infusion of INR115billion for PSBs in FY15.

IMPACT: A capital infusion of INR140billion has been budgeted for FY14. The allocation for FY15 may be in line with requirements under BASEL III norms; however, the proposed capital requirement will be reviewed in the full budget.

PHARMACEUTICALS

BUDGET PROPOSALS: Greenfield projects will get automatic approval, while brown field projects will require to be approved by the FIPB. Sops on R&D would continue.

IMPACT: This is expected to have a positive impact on FDI for greenfield projects. However, regulations and approval rules pertaining to FDI for the acquisition of Indian pharmaceutical companies are expected to be stringent.

CONSUMER ELECTRONICS

BUDGET PROPOSALS: The excise duty on all handsets has been made uniform at 6%.

IMPACT: Mobile phones priced below INR2,000 would be impacted by this, as the uniform excise duty will increase the price of these phones. The Finance Minister also gave sops to domestically manufactured phones, but most handsets (including those of homegrown brands such as Micromax and Karbonn) are imported.

GOLD

EXPECTATION: No major announcement was expected given the adverse impact of gold imports on the current account deficit.

BUDGET PROPOSALS: No announcements were made.

IMPACT: With the fiscal deficit coming in at 4.6%, below the budgeted 4.8%, some pressure on the rupee and current account deficit has eased. For 2015, the government expects the fiscal deficit to stand at 4.1% of the GDP, based on a 13.4% rise in revenues and total expenditure growth limited to 11%. We believe that the fiscal target for FY15 is very bullish, given that the projected deficit for this year is tied to the government pushing back some expenditure and fast forwarding tax and dividend collections. Hence, unless the fiscal containment is sustained, the rupee continues to remain stable and inflation falls further, we do not anticipate any significant rollback of gold imports and trading restrictions imposed over the past year or so.

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