

Pre Budget Expectations 2018-19

The forthcoming Union Budget on Feb 01, 2018 will be the first post-GST and last full year budget of the current government before general elections likely to be held in May 2019 and expectations are therefore running high of what the budget can or should deliver. The government however has limited financial leeway to propose any large scale populist spends.

The FM has the unpopular task of balancing economic with politics, and this time, the economics—prolonged rural distress and a delayed recovery in economic growth—is shaping the politics.

We think in the forthcoming Budget:

- Fiscal deficit for FY18 could be 3.4% (below 3.5% for FY17) vs Budgeted 3.2% of GDP (a slippage of 20 bps) due to higher divestment receipts and cutback in expenditure (mainly capital) offsetting the fall in GST collections and lower receipts from RBI and telecom receipts. Development spending was squeezed in FY18 as oil tailwind faded, tax collections slowed and due to lingering Pay Commission burden.
- Fiscal deficit for FY19 could be projected at 3.2% (thus being on the path to fiscal responsibility, though with some lag). It means that the plan to meet the 3% deficit target will be postponed by one year (to FY20) for the third time. **However as long as the variance is not large, (say not more than 20-30 bps for FY19), the international investors and the RBI (MPC meet scheduled for Feb 06-07, 2018) would not mind.**
- **For FY19, expenditure focus areas would be agriculture and housing.** In agriculture the GoI would focus on addressing the rural distress by price support mechanism where the market price of crops fall below the MSP. Capex focus could be on irrigation, food supply chain, rural roads and housing. We expect government spend to remain strong in schemes like MNREGA (jobs), PMAY (housing), PMKSY (irrigation), SBM (clean India), NHM (health), NEM (education), and the crop insurance scheme.
- With a large number of infrastructure projects in pipeline such as Bharatmala, Sagarmala, Bullet train, Housing for all, Smart City development etc, **we expect Budget to increase allocation towards roads, railways, housing and urban development.**
- **The government could rely on non-budgetary sources of funding to fund the government's ambitious programs in railways, roadways and waterways.** Budgetary allocations for capital spending are likely to be supplemented by extra-budgetary sources of funds such as institutional finance and market borrowings of the CPSEs, Railways as well as the NIIF.
- Policy interventions may be introduced to aid specific sectors, such as the rural sector, exporters or SMEs.
- On the taxes front, **we expect raising of exemption limits for individuals from Rs.2.5 lacs currently to Rs.3 lacs**, Period of holding for **LTCG being raised from the current 1 year to 2** (in line with immovable property) or 3 years, Deduction u/s 80CCF may be reintroduced for investment in Infra bonds. Some plugging of loopholes like bonus stripping may be undertaken.
- On the corporate level Corporate tax rate may be cut to 25% for companies with annual sales of upto Rs.200 cr (vs Rs.50 cr earlier) (Realistically, a step-down in the corporate tax rate may be introduced only in conjunction with paring of exemptions, to maintain revenue neutrality), **Corporate tax rate on insurance companies may be hiked gradually from the current 12.5%+SC** over few years to match with the normal corporate tax rate, IBC cases – clarification/legislation expected on treatment of tax including MAT on writebacks,
- To bring down the cost of power, **regulated RoE** for power generating, distributing and transmitting companies, **may be cut from the current 15.5%** in line with the soft interest rates prevailing in the system.
- Nominal GDP is expected to grow @9.5-10% in FY18 vs 11.75% expected at the start of the year. For FY19, the nominal GDP may be projected to grow @ 11.5% (7.3% + 4.2% inflation). **With real GDP growth in FY19 expected at 7.3% (estimates by World bank 7.3%, IMF 7.4%), India will still be the fastest growing economy in the world.**
- GST rules could be simplified and some GST rates may be lowered (though this may only be hinted at, as GST is now the prerogative of GST Council).
- Subsidies could be hiked due to food (price support mechanism), interest (affordable housing expansion) and Fuel (rising crude prices) offsetting part of the gains due to DBT in fertilisers. Absence of one time large payoffs like 7th pay commission will help in this.

As against **the divestment target** of Rs.72000 cr for FY18, the Govt may end up collecting more than Rs.90000 cr and **may project another Rs.80000 cr in FY19** (about 36 companies in line for strategic disinvestment). Apart from stake sale in PSUs, a second fund-raising exercise with the Bharat-22 ETF and/or stake sale in SUUTI stocks may also be considered.

The **average price of the Indian basket of crude oil is likely to rise to US\$65-70/bbl in FY19** from US\$56-59/bbl in FY18. This would create pressure on the government to reduce excise duties to temper inflation, while in balance pushing up the fuel subsidy.

The government has increased its rural spending (Ministry of Agriculture & Allied Activities + Ministry of Rural Development) sharply over the past three years. **As against average growth of ~9% in total spending, rural spending has grown at an average of ~16%.** This may cap a sharp rise in rural spending unless the revenues are projected to grow robustly in FY19.

India's best phase of inflation and CAD is now behind. CPI inflation could hover over RBI's target through FY19 and CAD to average 2.0-2.5% of GDP – highest since FY15. Global liquidity is likely to see synchronous withdrawal in 2018, which can potentially push global rates higher. All these means that **revival in tax revenue, especially on GST front, is critical to sustain development spending in the coming year.** Progress of IBC cases also needs to be tracked closely for its positive impact on credit discipline and unlocking of funds in the Banking space.

If crude prices settle at \$70-75+ in FY19 and/or GST collections do not grow robustly, then the stress on the fiscal deficit will become visible with its impact on inflation and interest rates. Otherwise CPI could hover @5% in H1CY18 and between 4 to 5% in H2CY18. 10 year bond yields could remain in the 7.1-7.6% band for better part of CY18.

Overall, we see few negatives from this budget. Possibilities of an unexpected large positive is also limited. Private consumption is expected to stay strong aided by Implementation of 7CPC by PSUs and State Govts; **2018 monsoon could be a concern.**

Recap bonds issue will postpone achieving 60% debt to GDP ratio in the next five years (current ratio 69%) by a few years. **More debt borrowing (due to higher fiscal deficit) is hence avoidable at this stage.** Also the damage to growth recovery on account of potential rate hikes, outweigh the benefits of a slightly expansionary fiscal policy at this stage.

Stocks in housing, infrastructure and 'rural' sectors have risen sharply in the past few months in anticipation of higher government spending. **The government's ability to spend will be impacted if GST revenues were to fail to pick up meaningfully** from current levels post the implementation of the e-way bill system from February 2018 and matching of invoices system subsequently.

The Indian market quote at 18X 12-month forward 'EPS' factoring in strong estimated 21% growth in the netprofits of the Nifty-50 Index leaving limited room for disappointment on either earnings or macroeconomic parameters.

Over theyears, the impact of the budget on the equitymarkets appears to have declined as the government has separated major policyannouncements from the budget process.The Union Budget could be less relevant after a few weeks as focus would again shift to global events, macroeconomics and earnings (which is the missing piece in the valuation game currently).

Fiscal prudence has been the hallmark of this government. A paper by an international organization observed that the three most important factors determining the choice of both rural and urban voters in 2014 elections were corruption, economic growth and inflation. **The FM will strive to promote growth while keeping inflation and fiscal discipline in mind. This rules out any major bout of populism in the Budget.** As far as election induced populist measures are concerned, given 15 months to election, **the fiscal push can come even outside the budget just before the next interim budget.**

Since 2010, the Sensex has gone up six times out of nine in the month after the budget. And the Sensex has also fallen eight out of nine times during the month prior to the budget. For the current year, markets have been rising (first in Oct 2017 and then in Jan 2018) without any significant corrections. Further Market volatility in the pre-budget period has been the lowest as compared to the past 10 budgets. Hence possibility of a large upmove post the Budget seems less likely. **While optically the FM will deliver what the masses and classes want (and hence no immediate disappointment), a lot will depend on the way the Government revenues and interest rates pan out in H1FY18.**

HDFC securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066 Compliance Officer: Binkle R. Oza Email: complianceofficer@hdfcsec.com Phone: (022) 3045 3600

HDFC Securities Limited (HSL) is a SEBI Registered Research Analyst having registration no. INH000002475.

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