Union Budget 2017-18 may not add much to FY18 GDP growth

Expect redistribution of wealth, not a fiscal stimulus

Demonetization is likely to bring in additional resources to the government with more individuals coming under the tax net. In this note, we argue that even if the Union government announces to redistribute the entire pool of additional resources to the general public in form of tax breaks or higher spending under Budget 2017-18, it may not add much to FY18 GDP growth. However, if the redistribution leads to higher investments, we could see some boost to GDP growth in the subsequent years. It is also likely that such redistribution could also convert savings/investments into consumption, which (as we have argued several times) is highly unsustainable and undesirable.

The market is expecting a fiscal stimulus following demonetization, and it will be interesting to see how the government acts to meet these expectations. In case the Union government announces to spend additional resources or convert them into tax breaks, we believe it may have little impact on FY18 GDP growth. Also, even if the government decides to relax its fiscal deficit target for FY18 (say from 3% to 3.5%), it may not necessarily stimulate the economy.

Against this backdrop, we will discuss in this note about the more general argument of how the government could stimulate the economy.

Union Budget 2017-18 unlikely to add much to FY18 GDP growth…

Redistribution may not impact FY18 GDP growth much. In the worst case scenario, it would convert investments/savings into consumption, which is highly unsustainable and undesirable

We expect the government to stick to its fiscal deficit target of 3% of GDP for FY18 *(Exhibit 1)*. Also, we are more likely to see redistribution of wealth rather than a fiscal stimulus. Following demonetization, tax evaders are expected to have to share a portion of their wealth with the government, which, in turn, is likely to be redistributed among honest tax payers (by cutting individual income tax rates or reducing corporate tax rate) and other domestic entities (by increasing its spending). However, we argue that such redistribution may not impact FY18 GDP growth much. In the worst case scenario, it would convert investments/savings into consumption, which (as we have argued several times), is highly unsustainable and undesirable.

Exhibit 1: Union government had revised its fiscal deficit targets in 2015-16 Union Budget (% of GDP)

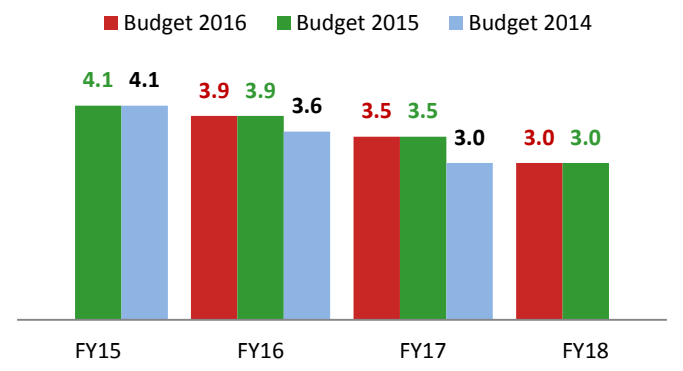
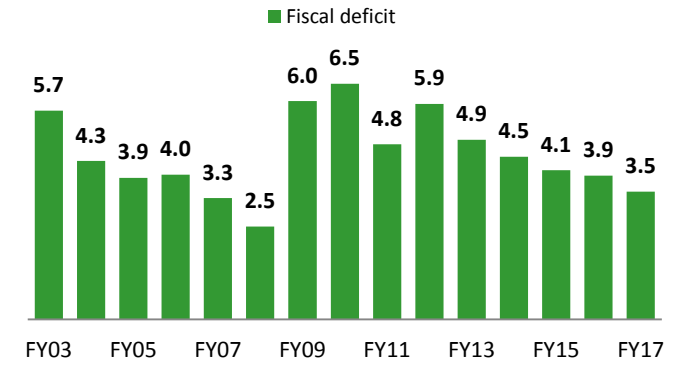


Exhibit 2: Longer-term trend in fiscal deficit of the central government (% of GDP)



Source: Union Budget documents, MoSL

Nikhil Gupta (Nikhil.Gupta@MotilalOswal.com); +91 22 3982 5405

Let's assume there are three parties: Mr Evader (group of people evading taxes earlier, but entering into the tax base in FY18), Mr Honest (including all honest tax payers and other private parties) and Mr Government. Since demonetization is expected to widen the tax base by bringing more individuals under the tax net, Mr Evader will have to share a portion of his wealth with Mr Government. In turn, Mr Government is expected to transfer these additional resources to Mr Honest (either via tax breaks or higher spending). In case Mr Evader was consuming these resources before paying them as taxes to Mr Government, we believe the mere transfer of this spending power from Mr Evader to Mr Honest should not lead to any net change in spending on domestically produced goods & services. There may certainly be a change in the composition of spending, but aggregate spending and thus GDP growth for FY18 will not be impacted much.

Alternatively, it is possible that Mr Evader was saving these resources rather than consuming. Mr Government would now consume such resources. Thus, domestic savings will be converted into consumption. In case these were financial savings of Mr Evader (held as currency), paying them to Mr Government will now reduce resources to finance non-household investments. If these were physical savings of Mr Evader, it reduces investments directly. In other words, the government will effectively convert investments/savings into consumption. Not only does this have hardly any impact on GDP, but it also replaces a sustainable driver of growth with an unsustainable one.

…however, it may help boost GDP growth in subsequent years – all depends on how government uses the additional resources

It is highly likely that the majority of additional resources will be redistributed in the form of tax breaks and higher revenue spending, leaving only a small portion for capital spending

Nevertheless, if the government chooses to use additional resources on capital spending, it may affect GDP growth positively in subsequent years but not in FY18. However, with the government almost unanimously expected to compensate Indian citizens for the pain incurred due to demonetization, it is highly likely that the majority of additional resources will be redistributed in the form of tax breaks and higher revenue spending, leaving only a small portion for capital spending. If this is the case, then it is unlikely to have any substantial impact on GDP growth for FY18 or any subsequent year.

Higher fiscal deficit may also not necessarily push GDP growth

We believe that unless higher fiscal deficit, during normal economic environment, is financed by the Reserve Bank of India (RBI) or foreign entities (to an extent), there is no incremental effect on GDP growth

Usually, fiscal stimulus is associated with higher-than-expected fiscal deficit in a particular year. Although we do not expect the government to breach its fiscal deficit target of 3% of GDP for FY18, we argue that even higher fiscal deficit and thus higher borrowings do not necessarily imply higher-than-otherwise GDP growth. Under normal circumstances, higher fiscal deficit has the potential to crowd out the private sector and is thus not desirable. We believe that unless higher fiscal deficit (during normal economic environment) is financed by the monetary authority or foreign entities (to some extent), there is no incremental effect on GDP growth.

Under the current scenario, although the private investments are under stress, private consumption is not. Thus, higher government borrowings should be exclusively used for capital spending

During slowdown and episodes of private sector stress, higher government borrowings convert private savings into consumption (to the extent of revenue spending) or investments (to the extent of capital spending). Under the current scenario, although private investments are under stress, private consumption is not (average growth of 7% over past four years). Thus, higher government borrowings should be exclusively used for capital spending, in our view. Nevertheless, the prior episodes make it clear that the government's ability to increase its capital spending is limited and that increasing government consumption is politically more feasible. However, the latter could potentially fuel inflationary pressures in the economy.

Higher fiscal deficit crowds out private sector under normal circumstances…

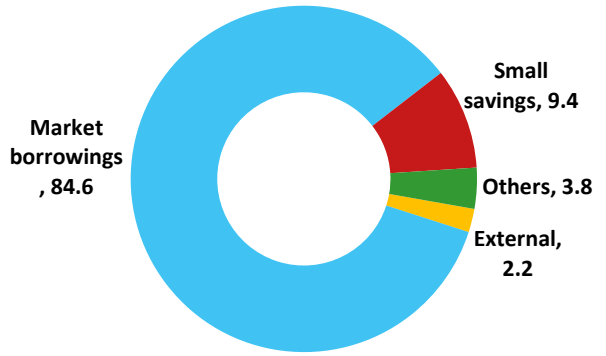
To understand this argument, one needs to answer a simple question: ***What is the source of funding for tax cuts or higher spending by the government?*** Let us engage in some thought experiments to understand this.

If the new government papers are bought by any domestic entity other than the monetary authority, it would not have any positive impact on demand of domestically produced goods & services in the economy

Let's assume that the government expands its fiscal deficit and decides to finance it through market borrowings, which account for ~85% of total fiscal deficit *(Exhibit 3)*. Let's further assume that commercial banks, which are the largest holder of dated government securities *(Exhibit 4)*, decide to invest in the new government papers (floated to borrow resources to finance fiscal stimulus). Where do the banks get money from to invest in government securities? It is likely to be from deposits, which were otherwise most likely to be used for credit to the private sector (considering normal economic environment). Thus, higher government borrowings, in this case, crowds out the private sector. Nevertheless, since banks have decided to divert their resources to the government (away from the private sector), there is no net change in total spending on domestically produced goods & services in the economy.

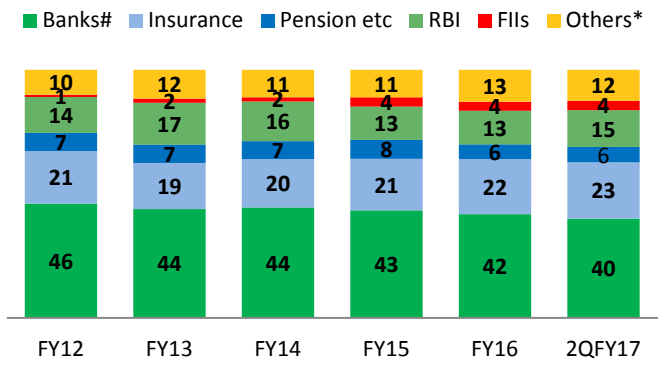
Similarly, if the new government papers are bought by insurance companies or pension funds or corporates or any domestic entity other than the monetary authority, it would not have any positive impact on demand for domestically produced goods & services. This is simply because higher government borrowing to spend more (or cut tax rates) simply replaces demand of some other domestic entity.

Exhibit 3: Key sources of financing central government fiscal deficit (% of total)



Based on average of the past three years

Exhibit 4: Key holders of dated government securities (% of total)



Source: Controller General of Accounts (CGA), RBI, CEIC, MoSL

However, in case the monetary authority (Reserve Bank of India (RBI) in India's case) funds the new government borrowings, it does not replace demand by any other domestic entity in the economy and thus creates more demand. This is because the RBI has the ability to create new money by buying additional government securities. This new money should ideally help create additional production of goods & services (or will lead to higher inflation).

Further, let's assume the new government securities are bought by foreign institutional investors (FIIs) – their share has increased from 1% in FY12 to ~4% by September 2016 *(Exhibit 4)*. In this case also, there is no offsetting impact on any other domestic entity, and the new money is brought in via foreign savings. If foreign capital inflows are converted into current account deficit (CAD), it will add to GDP growth. However, capital inflows sucked by the RBI (to build foreign exchange reserves) will not add anything to GDP growth. With higher CAD, FII purchase of government bonds will lead to additional demand for domestically produced goods & services. However, this positive impact on GDP growth could also be offset if higher CAD (higher imports or lower exports) replaces domestic production of goods & services.

Higher fiscal deficit leads to incrementally higher demand of goods & services if and only if the new borrowing is financed by either the monetary authority or by foreign entities (to some extent)

Thus, under normal circumstances, higher fiscal deficit leads to incrementally higher demand of goods & services if and only if new borrowing is financed by either the monetary authority or by foreign entities 9to some extent).

…while it may create unsustainable growth in the current environment

Banks' ability to invest more in government bonds will help convert domestic savings into government spending rather than exporting it to the rest of the world via improved current account balance

Nevertheless, it may not be fair to assume that the current economic environment is normal. It is conceivable that when the private sector (households/private corporate) is under immense stress, the government must increase its borrowings because it does not lead to crowd-out. Weak private investments in India reflect that commercial banks may have limited opportunity to lend to the private sector. Thus, its ability to invest more in government bonds will actually help convert domestic savings into government spending rather than exporting it to the rest of the world via improved current account balance.

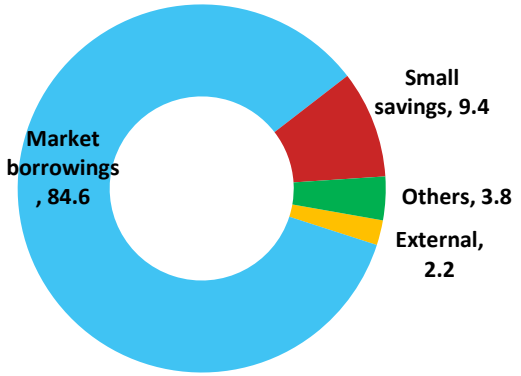
If the government has to stimulate the economy and increase borrowings (or fiscal deficit), it must focus on spending on infrastructure rather than revenue account

However, it is of utmost importance to monitor the quality of fiscal stimulus. For the Indian economy, while investment has grown at an average of only 2.5% for three years, private consumption has grown at 7% over the corresponding period. Therefore, if the government has to stimulate the economy and increase borrowings (or fiscal deficit), it must focus on spending on infrastructure rather than revenue account. This is in sharp contrast to developed economies, where very low inflation for several years gives sufficient room to the governments to spend more without worrying about the quality of stimulus. There are, however, two constraints in allowing wider fiscal deficit in the Indian economy. First, realistically, almost invariably, fiscal stimulus in the form of higher spending happens on revenue account rather than capital account. A look at the share of capital spending to total government expenditure reveals that the ratio has not moved dramatically over past few years *(Exhibit 5)*. Over the past decade, fiscal deficit has widened in three years – FY09, FY10 and FY12. Notably, capital spending declined in absolute terms in FY09, went up by 25% of the total increase in fiscal deficit in FY10 and increased by only 1% of higher deficit in FY12.

Central government alone cannot revive the investment cycle in Indian economy because it accounts for only ~6% of total investments in the economy

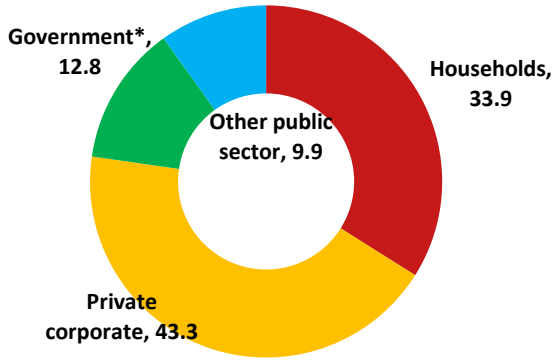
Secondly, the central government alone cannot revive the investment cycle in the Indian economy because it accounts for only ~6% of total investments *(Exhibit 6).* In FY15, the private corporate sector accounted for ~43% of total investments, while general government (Central + state governments) accounted for ~13%.

Exhibit 5: Change in capital spending during periods of fiscal stimulus over the past decade in India



Source: Central Statistics Office (CSO), Budget documents, MoSL

Exhibit 6: Break-up of investment (GFCF+ inventories) by different participants in FY15 (% of total)



* Central + state governments

In case, the government decides to pass on the entire pool of additional resources to the general public, it will not add much to FY18 GDP growth

Overall, we believe that the Union government is likely to stick to its self-imposed fiscal deficit target of 3% of GDP for FY18. In case, the government decides to pass on the entire pool of additional resources (collected due to a wider individual tax base) to the general public, it will not add much to FY18 GDP growth. However, there could be some boost to GDP growth in subsequent years to the extent that these additional resources are spent on capital account rather than redistributing to the general public as tax breaks (or spending on revenue account).

Further, we also argue that fiscal stimulus associated with expansion in fiscal deficit does not add anything to GDP growth during that year, unless new borrowings are financed by the monetary authority (or foreigners, to some extent). Under the current economic scenario in India, higher deficit makes sense only if the government decides to spend all additional resources on capital account, which is not an easy task.

Disclosures

This document has been prepared by Motilal Oswal Securities Limited (hereinafter referred to as Most) to provide information about the company (ies) and/sector(s), if any, covered in the report and may be distributed by it and/or its affiliated company(ies). This report is for personal information of the selected recipient/s and does not construe to be any investment, legal or taxation advice to you. This research report does not constitute an offer, invitation or inducement to invest in securities or other investments and Motilal Oswal Securities Limited (hereinafter referred as MOSt) is not soliciting any action based upon it. This report is not for public distribution and has been furnished to you solely for your general information and should not be reproduced or redistributed to any other person in any form. This report does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, investors should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur.

MOSt and its affiliates are a full-service, integrated investment banking, investment management, brokerage and financing group. We and our affiliates have investment banking and other business relationships with a some companies covered by our Research Department. Our research professionals may provide input into our investment banking and other business selection processes. Investors should assume that MOSt and/or its affiliates are seeking or will seek investment banking or other business from the company or companies that are the subject of this material and that the research professionals who were involved in preparing this material may educate investors on investments in such business . The research professionals responsible for the preparation of this document may interact with trading desk personnel, sales personnel and other parties for the purpose of gathering, applying and interpreting information. Our research professionals are paid on twin parameters of performance & profitability of MOSt.
MOSt generally prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, MOSt generally prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover. Our salespeople, traders, and other professionals or affiliates may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoingamong other things, may give rise to real or potential conflicts of interest. MOSt and its affiliated company(ies), their directors and employees and their relatives may; (a) from time to time, have a long or short position in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein. (b) be engaged in any other transaction involving such securities and earn brokerage or other compensation or act as a market maker in the financial instruments of the company(ies) discussed herein or act as an advisor or lender/borrower to such company(ies) or may have any other potential conflict of interests with respect to any recommendation and other related information and opinions.; however the same shall have no bearing whatsoever on the specific recommendations made by the analyst(s), as the recommendations made by the analyst(s) are completely independent of the views of the affiliates of MOSt even though there might exist an inherent conflict of interest in some of the stocks mentioned in the research report Reports based on technical and derivative analysis center on studying charts company's price movement, outstanding positions and trading volume, as opposed to focusing on a company's fundamentals and, as such, may not match with a report on a company's fundamental analysis. In addition MOST has different business segments / Divisions with independent research separated by Chinese walls catering to different set of customers having various objectives, risk profiles, investment horizon, etc, and therefore may at times have different contrary views on stocks sectors and markets.

Unauthorized disclosure, use, dissemination or copying (either whole or partial) of this information, is prohibited. The person accessing this information specifically agrees to exempt MOSt or any of its affiliates or employees from, any and all responsibility/liability arising from such misuse and agrees not to hold MOSt or any of its affiliates or employees responsible for any such misuse and further agrees to hold MOSt or any of its affiliates or employees free and harmless from all losses, costs, damages, expenses that may be suffered by the person accessing this information due to any errors and delays. The information contained herein is based on publicly available data or other sources believed to be reliable. Any statements contained in this report attributed to a third party represent MOSt's interpretation of the data, information and/or opinions provided by that third party either publicly or through a subscription service, and such use and interpretation have not been reviewed by the third party. This Report is not intended to be a complete statement or summary of the securities, markets or developments referred to in the document. While we would endeavor to update the information herein on reasonable basis, MOSt and/or its affiliates are under no obligation to update the information. Also there may be regulatory, compliance, or other reasons that may prevent MOSt and/or its affiliates from doing so. MOSt or any of its affiliates or employees shall not be in any way responsible and liable for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. MOSt or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement. The recipients of this report should rely on their own investigations.

This report is intended for distribution to institutional investors. Recipients who are not institutional investors should seek advice of their independent financial advisor prior to taking any investment decision based on this report or for any necessary explanation of its contents.

Most and it's associates may have managed or co-managed public offering of securities, may have received compensation for investment banking or merchant banking or brokerage services, may have received any compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months.
Most and it's associates have not received any compensation or other benefits from the subject company or third party in connection with the research report.
Subject Company may have been a client of Most or its associates during twelve months preceding the date of distribution of the research report

MOSt and/or its affiliates and/or employees may have interests/positions, financial or otherwise of over 1 % at the end of the month immediately preceding the date of publication of the research in the securities mentioned in this report. To enhance transparency, MOSt has incorporated a Disclosure of Interest Statement in this document. This should, however, not be treated as endorsement of the views expressed in the report.

Motilal Oswal Securities Limited is registered as a Research Analyst under SEBI (Research Analyst) Regulations, 2014. SEBI Reg. No. INH000000412

Pending Regulatory inspections against Motilal Oswal Securities Limited:
SEBI pursuant to a complaint from client Shri C.R. Mohanraj alleging unauthorized trading, issued a letter dated 29th April 2014 to MOSL notifying appointment of an Adjudicating Officer as per SEBI regulations to hold inquiry and adjudge violation of SEBI Regulations; MOSL replied to the Show Cause Notice whereby SEBI granted us an opportunity of Inspection of Documents. Since all the documents requested by us were not covered we have requested to SEBI vide our letter dated June 23, 2015 to provide pending list of documents for inspection.

List of associate companies of Motilal Oswal Securities Limited -Click here to access detailed report

Analyst Certification

The views expressed in this research report accurately reflect the personal views of the analyst(s) about the subject securities or issues, and no part of the compensation of the research analyst(s) was, is, or will be directly or indirectly related to the specific recommendations and views expressed by research analyst(s) in this report. The research analysts, strategists, or research associates principally responsible for preparation of MOSt research receive compensation based upon various factors, including quality of research, investor client feedback, stock picking, competitive factors and firm revenues

Disclosure of Interest Statement	Companies where there is interest
▪ Analyst ownership of the stock	No
▪ Served as an officer, director or employee	No

A graph of daily closing prices of securities is available at www.nseindia.com and http://economictimes.indiatimes.com/markets/stocks/stock-quotes

Regional Disclosures (outside India)

This report is not directed or intended for distribution to or use by any person or entity resident in a state, country or any jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject MOSt& its group companies to registration or licensing requirements within such jurisdictions.

For Hong Kong: This report is distributed in Hong Kong by Motilal Oswal capital Markets (Hong Kong) Private Limited, a licensed corporation (CE AYY-301) licensed and regulated by the Hong Kong Securities and Futures Commission (SFC) pursuant to the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) "SFO". As per SEBI (Research Analyst Regulations) 2014 Motilal Oswal Securities (SEBI Reg No. INH000000412) has an agreement with Motilal Oswal capital Markets (Hong Kong) Private Limited for distribution of research report in Kong Kong. This report is intended for distribution only to "Professional Investors" as defined in Part I of Schedule 1 to SFO. Any investment or investment activity to which this document relates is only available to professional investor and will be engaged only with professional investors." Nothing here is an offer or solicitation of these securities, products and services in any jurisdiction where their offer or sale is not qualified or exempt from registration. The Indian Analyst(s) who compile this report is/are not located in Hong Kong & are not conducting Research Analysis in Hong Kong.

For U.S

Motilal Oswal Securities Limited (MOSL) is not a registered broker - dealer under the U.S. Securities Exchange Act of 1934, as amended (the"1934 act") and under applicable state laws in the United States. In addition MOSL is not a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act" and together with the 1934 Act, the "Acts), and under applicable state laws in the United States. Accordingly, in the absence of specific exemption under the Acts, any brokerage and investment services provided by MOSL, including the products and services described herein are not available to or intended for U.S. persons.

This report is intended for distribution only to "Major Institutional Investors" as defined by Rule 15a-6(b)(4) of the Exchange Act and interpretations thereof by SEC (henceforth referred to as "major institutional investors"). This document must not be acted on or relied on by persons who are not major institutional investors. Any investment or investment activity to which this document relates is only available to major institutional investors and will be engaged in only with major institutional investors. In reliance on the exemption from registration provided by Rule 15a-6 of the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act") and interpretations thereof by the U.S. Securities and Exchange Commission ("SEC") in order to conduct business with Institutional Investors based in the U.S., MOSL has entered into a chaperoning agreement with a U.S. registered broker-dealer, Motilal Oswal Securities International Private Limited. ("MOSIPL"). Any business interaction pursuant to this report will have to be executed within the provisions of this chaperoning agreement.

The Research Analysts contributing to the report may not be registered /qualified as research analyst with FINRA. Such research analyst may not be associated persons of the U.S. registered broker-dealer, MOSIPL, and therefore, may not be subject to NASD rule 2711 and NYSE Rule 472 restrictions on communication with a subject company, public appearances and trading securities held by a research analyst account.

For Singapore
Motilal Oswal Capital Markets Singapore Pte Limited is acting as an exempt financial advisor under section 23(1)(f) of the Financial Advisers Act(FAA) read with regulation 17(1)(d) of the Financial Advisors Regulations and is a subsidiary of Motilal Oswal Securities Limited in India. This research is distributed in Singapore by Motilal Oswal Capital Markets Singapore Pte Limited and it is only directed in Singapore to accredited investors, as defined in the Financial Advisers Regulations and the Securities and Futures Act (Chapter 289), as amended from time to time.

In respect of any matter arising from or in connection with the research you could contact the following representatives of Motilal Oswal Capital Markets Singapore Pte Limited:
Varun Kumar
Varun.kumar@motilaloswal.com
Contact : (+65) 68189232
Office Address:21 (Suite 31),16 CollyerQuay,Singapore 04931