FRANKLIN TEMPLETON INVESTMENTS

Union Budget 2009-10

JULY 06, 2009

A Perspective

Salient Points

- GDP growth rate estimate for 2008-09 at 6.7%. Aim to bolster it to 9% over the medium term
- Gross domestic savings & the rate of gross capital formation increased to 37.7% & 34% of GDP, while per capita income rose by 4.6%
- A clear emphasis on bolstering infrastructure, rural economy, agriculture and relief to exporters.
- Additional support for financing needs of infrastructure projects.
- Revenue & fiscal deficits for FY 10 targeted at 4.8% and 6.8%, respectively (compared to 4.6% and 6.2% in the previous fiscal year).
- **Taxation :**
  - No change in corporate rates and Minimum Alternate Tax increased to 15% of book profits from 10%.
  - Commodity Transaction Tax (CTT) abolished
  - Direct : a) Threshold limit for income tax exemption increased by Rs.10,000 for all individual and women tax payers, while the exemption limit has been increased by Rs.15,000 to senior citizens. b) Surcharge of 10% on income tax removed c) Fringe Benefit Tax abolished
- Goods & Services Tax (GST) to be implemented by April 2010 with dual GST comprising of Central and State GST

Inclusive Growth remained the main focus area for the Union Budget and there were no big reform announcements. This has been in line with recent trends wherein most of the key policy initiatives are announced throughout the year. As expected, the fiscal deficit projections have come in higher taking into account the recent fiscal stimulus measures and slowdown in tax revenues. The latest spending plans, aimed at boosting economic growth in an inclusive manner, are likely to put additional pressure on the fiscal health.

The various measures and additional spending plans could help in ensuring that a significantly larger social strata across the country participates in the economic growth opportunities, and as benefits of these new initiatives trickle down, the overall economic activity is likely to get a boost over the medium to long term. The increase in tax exemptions and the removal of FBT/income tax surcharge will boost disposable incomes.

Few of the earlier excise duty cuts were reversed, incentives given to investment related sectors and duties on gold and silver imports increased – overall impact of direct tax measures is neutral while indirect tax changes will lead to additional revenues. The definitive timeline for implementation of GST (along with the soon-to-be-released Direct Taxes Code) is a positive as it would boost the tax-to-GDP ratio by widening the tax net to the unorganized sector.

One of the key concerns has been the lack of clarity for achieving fiscal consolidation. While fiscal deficits across the globe have widened due to aggressive stimulus measures, India already has a relatively high fiscal deficit number

(Centre plus States). This needs to be tackled by reducing wasteful expenditure, attracting capital and improving tax efficiency. While increased spending should help, the key is to avoid systemic leakages and ensure effective implementation.

EQUITY MARKETS

Markets reacted negatively to the lack of any pro-reformist announcements in the Union Budget and the sharp increase in the fiscal deficit. The positive electoral mandate for the ruling coalition had brought about expectations of major reform announcements and the absence of the same led to weak market sentiment. Also there were worries about spending on populist measures resulting in a reversal of the fiscal consolidation trends witnessed in recent years. Indices across the market cap range came under pressure during the day

% change	From Friday's close		From Friday's close
BSE Sensex	-5.83%	BSE Realty	-7.28%
S&P CNX Nifty	-5.84%	BSE Power	-6.36%
BSE MidCap	-5.17%	BSE FMCG	0.97%
BSE SmallCap	-4.50%	BSE IT	-2.74%
BSE Bankex	-8.17%	BSE Healthcare	-1.88%
BSE Oil & Gas	-5.51%	BSE PSU	-5.51%
BSE Metals	-6.52%	BSE CG	-7.02%

PSU entities, including banks, fell on the announcement that they will remain under public control, while shares of consumer oriented companies benefited. Sectors that had moved up sharply in recent weeks came under selling pressure - capital goods, real estate and metals.

Given the steep rally over a short time period, there could be consolidation as investors digest fresh earnings and economic data. Given low interest rates and economic growth across the world, global investors are focusing on countries that are likely to grow at a relatively faster pace. India deserves a valuation premium to its peers due to higher RoE levels and high domestic demand component in earnings. As companies raise capital to meet ongoing capex and infrastructure expenditure, we could see an increase in investment growth. Though, the large equity issuance pipeline could cap market upside in the near future.

DEBT MARKETS

The higher-than-expected jump in projected fiscal deficit put pressure on the debt markets and yields firmed up, especially at the long end of the curve. Investors were taken aback by the jump in spending and lack of clarity on the framework for medium-term fiscal consolidation.

Yields (%)	06.07.2009	03.07.2009
1-yr Gilt	4.00	3.90
5-yr Gilt	6.45	6.27
10-yr Gilt	6.92	6.81
30-yr Gilt	7.93	7.71
5-yr Corporate Bonds (AAA)	8.10	7.85

RBI is expected to actively manage the borrowings programme to ensure that it is not disruptive and does not crowd out private borrowers. SLR holdings of banks have come down and this could provide support for government bonds at lower levels. Meaningful progress on the divestment and spectrum sale fronts could alleviate some of the pressure due to government borrowings. The rupee might strengthen if the current momentum of capital inflows (FII/FDI) continues as India remains an attractive investment destination

Given the quantum of borrowings for the rest of the year, we are likely to witness additional pressure on the long end of the curve and a contraction in corporate spreads due to the economic growth and additional flows into the system. The short-end of the curve is expected to be steady helped by the monetary easing. RBI also has additional headroom for managing increased supply through continuation of its OMO programme, MSS unwinding and additional cuts in CRR.

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