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A NEWSLETTER OF THE FINANCE LAB

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INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

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Editorial

The digital revolution in the financial sector is causing great waves. Innovations in products and services in financial technology (Fintech) sector are changing the rules of the game in finance industry. Technology-driven providers, which are not banks, are entering the market for simple financial services. The offerings of the new players include digital payment solutions, online banking, robo-advisory services. Recognising tremendous opportunities investments in Fintech ventures crossed US$15 billion globally. A large number of boutique Fintech startups are providing solutions of great value. Banks, which initially ignored the Fintech industry, are now scared to be disrupted. The new-age Fintech has forced banks to substantially increase their investments in technology. Analysts well versed in artificial intelligence, machine learning and data mining techniques are busy in generating algorithms/alerts that provide information on investors' behaviour, fraud detection and abnormal transactions. The banking and financial services industry is eagerly watching the developments in Fintech. It would be prudent for banks to collaborate with these smart innovators to improve customer experience in banking.

In the first article, the author discusses the recent share buyback programme of Indian IT Firms and its effect on market. Buyback is used to return free cash flows to shareholders. The author observed that there is no guarantee, that share buyback would improve EPS and share price.

In the second article, the author analyses the Union Budget 2017-18. In general, the budget has received positive response except some concerns related to banks' recapitalization and passive private investment.

The *Market Watch* section in this issue highlights Chinese currency market and Depreciation in Euro.

You may send your comments and feedback on this issue to ashok@iimcal.ac.in.

Happy reading!

Ashok Banerjee

Share Buyback and Indian IT Firms: Any Signal?

Ashok Banerjee[1]

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Seven software companies in India have either announced or discussed buyback of shares programme within a span of 45 days, between 31 January 2017 and 15 March 2017. Excepting one company (Mindtree), others have also declared the size of buyback totaling US$5.8 billion. The seven companies have more than US$23 billion in cash, cash equivalents and short-term investments. Therefore, the proposed buyback amounts to 30% of the free cash available with these companies. TCS has announced India's biggest buyback offer till date (Rs. 160 billion) surpassing Reliance Industries Ltd's buyback offer of Rs.104 billion in 2012. The buyback price of Rs.2850 represents a 13.7% premium to the closing share price of 20 February 2017 when the announcement was made. The buyback will involve 2.85% of the company's outstanding shares. Interestingly Tata Sons, the holding company, has decided to participate in the buyback of TCS shares. Tata Group owns 73% of TCS and hence if the holding company does not participate in the buyback, the promoter group may reach closer to 75% mark endangering listing of TCS in the exchange. Legal technicalities apart, participation of a holding company in any buyback programme sends a wrong signal to the market.

Reports suggest that the Board of Wipro is seriously considering distributing 25-30% of its free cash reserve to its shareholders. Wipro had a free cash reserve of US$3 billion in March 2016 which grew to US$4.9 billion in December 2016. The expected buyback size is US$1.25 billion. This is in addition to the interim dividend of about Rs. 500 crore (US$75 million) declared by the company in January 2017. Cognizant, the US-based Nasdaq-listed company, had announced in January 2017 its decision to return US$3.4 billion cash to shareholders over next two years through dividend (US$0.7 billion) and buyback (US$2.7 billion). The company has free cash reserve of US$5.3 billion as on 31 December 2016.

[1] The author acknowledges data support provided by Ms. Leesa Mohanty, a Post-Doctoral Research Fellow at IIM Calcutta

Responding to the pressure of select founders, Infosys is likely to soon announce share buyback to the tune of US$2.5 billion. Infosys has more than US$5 billion of free cash and hence the expected buyback would consume almost 50% of the cash reserve of the company. However, Infosys has no plans to implement the buyback programme before 2018. If approved, this will be Infosys's first share buyback programme. One may note that in the recent past there was a bit of tension between the founders and the Board of Infosys on issues of severance pay to the CFO of the company and compensation for the CEO. Founders presently hold about 13% of the company.

HCL Technologies has announced a share buyback programme to the tune of US$500 million. It represents 2.45% of paid up equity capital of the company and about 14% of the consolidated equity of the company. HCL has cash reserve of close to US$1.9 billion. The proposed buyback at Rs. 1000 per share reflects a premium of 15% to the closing price of the share on the day before the announcement. Mphasis has obtained shareholders' nod for its buyback programme of US$200 million, which is 8.2% of the paid up capital of the company. Similarly, Mindtree is also going to announce its buyback programme soon.

Signalling

Buyback is typically used to return free cash flows to shareholders. Announcement of share buyback, therefore, sends several signals. *First*, large distribution of cash reserves indicates that a firm may not have immediate profitable investment opportunities and thus allowing its investors opportunity to earn better return on their investments. *Second*, it indicates confidence of the company to replenish its cash reserve quickly after buyback with insignificant negative impact on the net earnings (profit) of the firm. *Third*, it may also signal lack of confidence on the part of management in facing future uncertainties. For example, in view of severe restrictions imposed by the US on H1B visa the Indian IT firms fear substantial drop in business volume from USA. If a software firm in such a situation announces share buyback, it may send a signal that the firm is unsure of its future and therefore wants to keep its shareholders happy by way of share buyback.

It is clearly evident (Table 1) that these software firms were earning suboptimal returns on their free cash (yield on free cash is very low) and hence their decision to return the cash to shareholders is justified. It is also noticed that the firms, due to very nature of their business, need little investment in real assets (capital expenditure) and hence distribution of large cash to shareholders would not materially affect the business. Experts believe that the recent developments in the US have provided an opportunity to the Indian firms to revisit their strategy and tweak their model away from labour-intensive low-margin business. These firms have to explore opportunities in the area of artificial intelligence, machine learning and cognitive analytics much of which are outside the present domain of these entities. Indian firms need to adopt the 'acquisition' route to quickly get into these new areas of high-margin business. Inorganic growth requires availability of cash reserve. The leading software firms (Table 1) have already distributed more than US$9 billion in the past three years by way of dividend and still hold more than US$20 billion of cash and short-term investments. This implies that proposed buyback offers of the seven companies would not compromise with the long-term business objective of these firms. The only challenge it to learn how to identify potential candidates for acquisition.

Table 1: Free Cash Flow Usage	2016	2015	2014	Total
TCS				
Net Capex	225.02	1703.33	1621.86	3550.21
Cash and Cash equivalents	28827.1	19746	15649.5	
Cash Dividend	8571.38	15473.87	6267.33	30312.58
Yield of free cash	6%	8%	8%	
Cognizant Technology Solutions				
Net Capex	-530.78	- 365.67745	25.241504	-871.213
Cash and Cash equivalents	35,137.00	32,778.96	23,865.54	
Cash Dividend	0	0	0	0
Yield of free cash	2%	2%	2%	
Infosys				
Net Capex	1,193.00	1,073.00	1,389.00	3655
Cash and Cash equivalents	29,178.00	28,471.00	26,849.00	
Cash Dividend	5570.00	5111.00	3618.00	14299
Yield of free cash	9%	9%	8%	
Wipro				
Net Capex	189.50	95.50	(66.40)	218.6
Cash and Cash equivalents	21,139.00	20,131.30	16,394.10	
Cash Dividend	1482.30	2963.60	1973.60	6419.5
Yield of free cash	10%	8%	8%	
HCL Technologies				
Net Capex	368.51	759.37	114.36	1242.24
Cash and Cash equivalents	11852.90	9999.80	4204.30	
Cash Dividend	2251.74	2385.59	700.27	5337.6
Yield of free cash	5%	8%	13%	
Mindtree				
Net Capex	26.10	97.80	71.10	195
Cash and Cash equivalents	402.50	901.20	633.50	
Cash Dividend	176.20	142.40	104.10	422.7
Yield of free cash	4%	2%	1%	
Mphasis				
Net Capex	23.83	9.13	-0.41	32.55

Cash and Cash equivalents	1388.51	944.73	1032.91	
Cash Dividend	0.00	336.23	147.13	483.4
Yield of free cash	4%	5%	1%	

Source: Ace Equity and Bloomberg. Figs in Rs. Crore unless mentioned otherwise
Net Capex= Capital expenditure-Depreciation

Shareholder Activism

Another reason for a company to announce share buyback could be the pressure of shareholders. Promoters majorly control the equity ownership of most of the software companies in India. Cognizant Technologies, which is a US-based company, is an exception where investment and hedge funds hold major shares (Table 2). One may wonder why all these seven companies announced share buyback this year? Wipro, of course, had declared another buyback in the recent past. The reason could be pressure from the institutional investors. For example, foreign portfolio investors are known to exert pressure on companies to distribute cash to shareholders. It is observed that foreign portfolio investors held 40.24% of Infosys shares, 26.94% of HCL's and 10.93% of Wipro's in 2016 and these group of shareholders did not hold any shares of these companies in 2015 or earlier. Empirical evidence suggests that shareholders often put pressure on firms to distribute idle cash, which is not earning optimal returns. Such active shareholders always demand a transparent capital return policy. For example, Elliott Management, which holds 4% stake in Cognizant Technology Solutions (CTS), demanded a $2.5 billion share buyback, interim dividend and a shakeup in management of the company to improve profitability. Incidentally, CTS has never paid any dividend since its inception. Similarly in 2014 two former chief financial officers and a serving board member of Infosys had formally written to the board of the company demanding share buyback worth US$2 billion. Generally shareholders of IT firms in India were not happy with the returns over the past three years and believed that buyback may boost the share price and hence value of their investment.

Table 2: Shareholding Pattern	2016	2015	2014
TCS			
Promoters	73.42	73.9	73.9
Institutions	22	21.64	21.47
Public (Non-Institutions)	4.58	4.46	4.64
Cognizant Technology Solutions			
Investment Advisor	83.64	88.73	84.74
Institutions (incl hedge fund)	13.51	9.09	13.05
Public (Non-Institutions)	2.85	2.18	2.21
Infosys			
Promoters	12.75	13.08	15.94
Institutions	57.69	53.06	55.76
Public (Non-Institutions)	28.58	17.66	12.2
ADR	0.98	16.2	16.1

Wipro			
Promoters	73.34	73.39	73.47
Institutions	16.18	15.07	13.62
Public (Non-Institutions)	9.93	9.58	10.97
ADR	0	1.96	1.94
HCL Technologies			
Promoters	60.38	60.58	61.64
Institutions	32.63	33.45	32.58
Public (Non-Institutions)	7	5.97	5.77
Source: Ace Equity. Figures in percentage			

Market Reaction

The IT firms had three choices with regard to their capital return policy: (a) do nothing (i.e., retain the free cash), (b) distribute the free cash as a special dividend, and (c) share buyback. Table 3 shows the implications of these three choices.

It is assumed that if every firm does nothing with existing free cash, the share price would not change and the price shown is the share price on the date of announcement of buyback. Further, the special dividend is assumed to be equal to the size of buyback announced or discussed. The ex-dividend price is estimated by deducting dividend per share from the share price under 'retain cash' option. Loss of income due to use of free cash (equivalent to yield of free cash multiplied by the proposed buyback size) is deducted from earnings estimates for dividend and buyback options.

Table 3	**Share Price (Rs.)**	**2018 Earnings (Rs. million)**	**Number of Shares (million)**	**EPS (Rs.)**	**DPS (Rs.)**	**#shares repurchased (million)**
TCS						
Retain Cash	2502.2	283721.9	1970.4	144.0	0.0	
Special Dividend	2430.9	275535.4	1970.4	139.8	71.3	
Repurchase Shares	2489.9	275535.4	1914.3	143.9	0.0	56.2
One-week Market Reaction	-1%					
Cognizant Technology (figs in USD)						
Retain Cash	57.4	2227.7	607.0	3.7	0.0	
Special Dividend	53.0	2173.7	607.0	3.6	4.4	
Repurchase Shares	58.0	2173.7	560.0	3.9	0.0	47.0
One-week Market Reaction	-1%					
Infosys						
Retain Cash	936.5	155847.7	2296.9	67.9	0.0	
Special Dividend	930.2	141461.7	2296.9	61.6	6.3	

Repurchase Shares	981.8	141461.7	2118.1	66.8	0.0	178.9
One-week Market Reaction	5%					
Wipro						
Retain Cash	488.6	91861.1	2470.7	37.2	0.0	
Special Dividend	454.7	83725.0	2470.7	33.9	33.9	
Repurchase Shares	495.1	83725.0	2299.3	36.4	0.0	171.4
One-week Market Reaction	2%					
HCL Technologies						
Retain Cash	842.9	89700.3	1410.4	63.6	0.0	
Special Dividend	818.4	87825.7	1410.4	62.3	24.5	
Repurchase Shares	864.4	87825.7	1375.8	63.8	0.0	34.6
One-week Market Reaction	2%					

Source: Bloomberg for consensus estimates of earnings for 2018

It is observed that earning per share (EPS) would not increase in most of the cases after buyback. The market reaction, based on share price change in one week after the announcement of buyback), has been positive in three out of five cases. Market reaction is estimated as excess return over NIFTY (NASDAQ in case of Cognizant). Thus, there is no guarantee, as some shareholder activists argue, that share buyback would improve EPS and share price. Buyback should be used more as a signalling mechanism.

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Macroeconomic Perspective of India's Union Budget 2017-18

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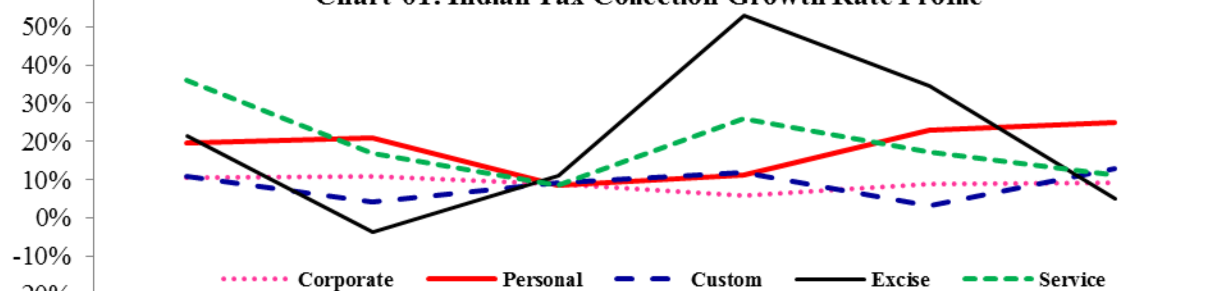
The Union Budget 2017-18 (UBFY18), in general, appears composed on its proposals except for some concerns related to banks' recapitalization and passive private investment. The proposal positivity lies in its fiscal prudence (despite minor divergence of 0.2% up against mandated 3.0% under Fiscal Responsibility and Budget Management Act: FRBMA by 2017-18) and adherence to past commitments despite pressures generated from slower economic growth. Other attractive features of the UBFY18 are pursuance of digital economy, emphasis on infrastructure development, revival of rural economy (including affordable housing for the poor /underprivileged) and effort of simplification in the tax regime. The sharp rise in budgetary allocation on capital expenditure signals the government's strong willingness to revive economic activity through public spending and generating crowd-in effect for private investment.

Given the structure and composition of rural economy in the overall Indian economy (due to its high demographic dependence albeit weakest contribution share), the budget proposal of doubling farmers' income by 2022 seems to be catalyzing event for the rural economic activity. The government proposes agricultural credit of Rs 10 lakh crore for farmers and 60 days of interest waiver apart from strengthening of functional primary Agricultural Credit Societies network in next 3 years through NABARD at a cost of Rs 1900 crore. The UBFY18 stresses on further expansion of 'Fasal Bima Yojana' (up to coverage of 50% in FY19), more Krisi Vigyan Kendras (for coverage of soil sample testing with 100% coverage), irrigation network (including micro-irrigation) and national agricultural market (e-NAM: from existing 250 to 585 APMCs). The corpus for dairy processing and infrastructure development has been increased from Rs 2,000 crore to Rs 8,000 crore.

The government has proposed an annual allocation of Rs 3.0 lakh crore (grant-in-aid) for rural areas for providing basic infrastructure and employment through capital creation such as PMGSY roads, farm ponds and rural housing. The MGNREGA schemes also get all-time high allocation of Rs 48,000 crore in FY18 budgetary proposals. Another attraction of the UBFY18 is a proposal to construct 1 crore rural houses by 2019 (with budgetary allocation of Rs 23,000 crore). Target of 100% village electrification (by May 1, 2018) and skilling 5 lakh persons (by 2022) are other important budgetary proposals. The extension of safe drinking water network under National Rural Drinking Water Programme to 28,000 habitations in the next four years is another attractive rural welfare proposal. The government also proposes legislative reforms for existing labor laws on four codes of wages, industrial relations, social security and welfare and safety and working conditions. Any progress on these fronts could prove to be a positive support to the Indian rural economy in terms of better infrastructure and higher employability.

Despite high expectations from the budget, the government managed to keep budgetary proposals balanced except for marginal incentives in personal tax rates reduction, by slashing minimum tax rate from existing 10% to 5% for the lowest income bracket (up to Rs 5 Lakh) of tax payers. Although this proposal would generate downward pressure on personal tax collections due to its scale (under-reporting) linkages, any improvement in tax compliance in this income group under pursuance of digitalized economy after demonetization may neutralize the loss and has capacity to bring more positivity through multiplier effect.

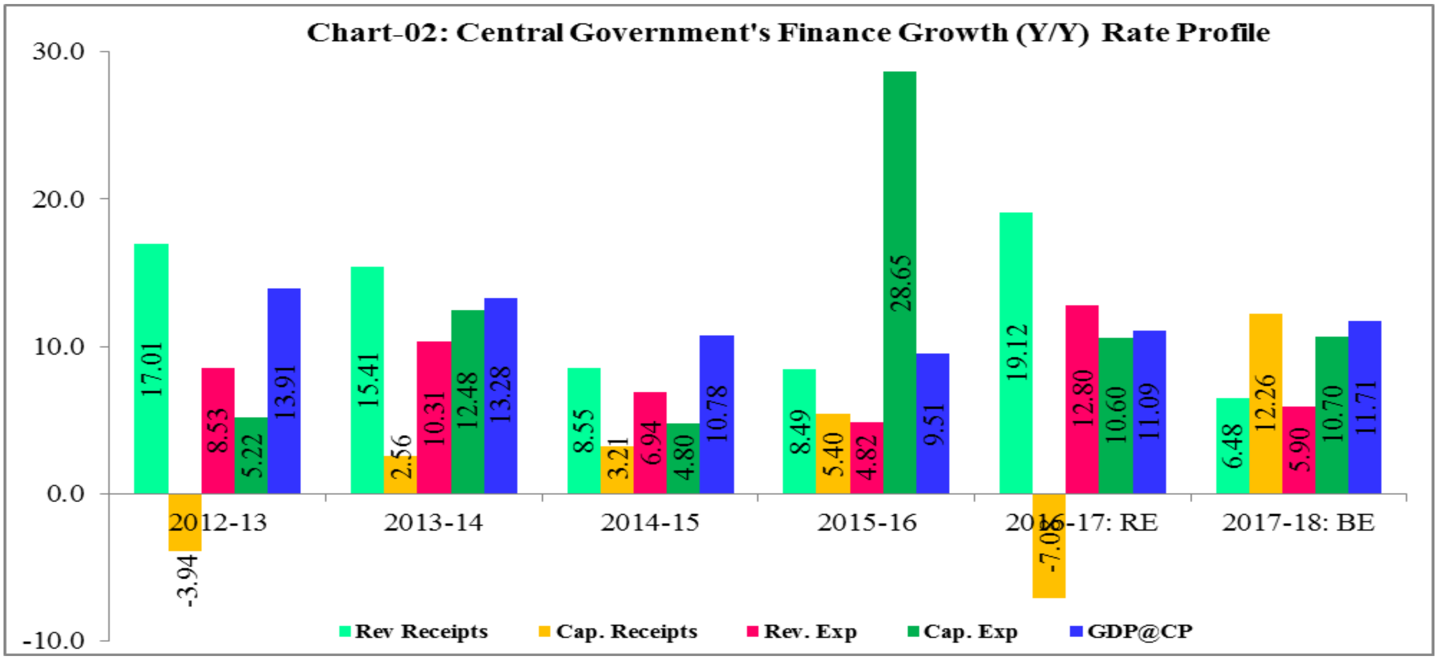
Chart-01: Indian Tax Collection Growth Rate Profile



	FY13	FY14	FY15	FY16	FY17	FY18
Corporate	10%	11%	9%	6%	9%	9%
Personal	19%	21%	9%	11%	23%	25%
Custom	11%	4%	9%	12%	3%	13%
Excise	21%	-4%	11%	53%	34%	5%
Service	36%	17%	9%	26%	17%	11%

An imposition of 10% additional surcharge on annual income higher than Rs 50 lakh to Rs 1 crore seems as a loss-mitigating move. The proposal of 5% reduction in corporate tax for MSMEs with turnover up to Rs 50 crore to 25% is a welcome step especially for manufacturing industry, (under ‘Make in India’ programme), given their dominance in the overall production profile. This proposal is an incentivizing step for MSMEs for greater entrepreneurial exploration on one hand, while a great positive proposition in creating of more jobs (for low skilled labor force) through cost reduction and diversifying product profile. The loss in corporate tax collections due to this reduction can be mitigated through better tax collection prospects on account of improvement in economic activity and employability.

The analysis of government's financial proposal, shows that government's receipts would grow at 9.7% (a 4-year high) to Rs 21,21,046 crore in FY18, particularly on high growth of capital receipts (12.3%) along with high-base effect growth in revenue receipts (6.5%, a six-year lower growth projection) displaying incorporation of adverse impact of slower economic growth expectations. Although relatively slower growth expectation in excise duty (5.0% in FY18 against 34.5% in FY17) and service tax (11.1% against 17.1%) collection reflects impact of tax relief to MSMEs and service providers for digitalization acceptance, higher growth projection for personal income tax (24.9% against 22.8%) appears strongly based on assumption of broadening in tax base on scale.



However slower growth in budgeted expenditure (6.6%) seems to be realistic despite fiscal pressures generating from implementation of due installments of OROP scheme and ongoing social welfare expenditure, particularly on account of reduction in systemic leakages. The same can be observed from relatively slower growth in revenue expenditure (5.9%: BE in FY18 against 12.8% in FY17) than that of capital expenditure (10.7% against 10.6%) reflecting government's seriousness in capital creation especially in infrastructure sector (railways, roads and ports). The sharp rise of 28.7% in the FY16's capital expenditure (including grants for creation of capital assets) shows the government's commitments of capital creation through various governmental channels.

As net market borrowing through government securities is projected marginally higher at Rs 3,48,226 crore (BE) in FY18 compared to Rs 3,47,219 crore (RE) in FY17, showing relatively better position of the government's finance despite higher allocation on expenditure budget. Hence this budgetary proposal is expected to keep interest rate pressures under check, particularly due to stable domestic macroeconomic factors and limited exposure to external risks. Higher buyback/switching plan (Rs 1 Lakh crore) and Ways & Means inflows (Rs 3 Lakh crore) may create downward borrowing pressures through expectation channel and thus lower interest rate expectation. The same can be observed from relatively lower average 10-year benchmark G-Sec yield (7.00%) during April'16 – February'17 compared to 7.79% in FY16. Although excess systemic liquidity, lower domestic policy rate and a decline in SLR requirement (20.5% from 20.75%) would keep G-Sec yields range-bound in a narrow corridor in the next fiscal year; any quicker winding up process of excessive accommodative monetary policy in advanced economies may generate some short-term upward pressure.

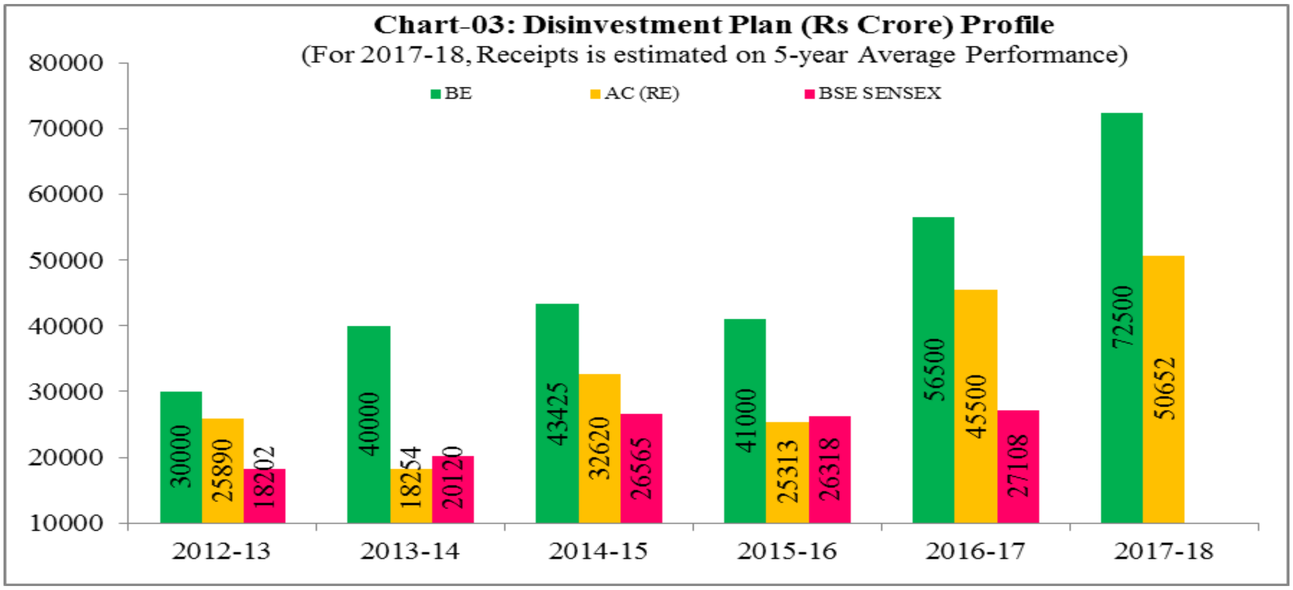
Table-01: Market Borrowing, Outstanding G-Sec, Liquidity (Re Crore) and Interest Rate Profile

	Market Loans			Average Daily	
F-Year	**Gross Market Loan**	**Net Market Loan**	**Outstanding G-Sec Amount**	**Net LAF Liquidity (+ Variable LAF)**	**10Y Benchmark G-Sec Yield (%)**
2011-12	509796	436211	3808417	-79947	8.370
2012-13	558000	467356	4456263	-85084	8.156
2013-14	563675	468668	5116974	-89167	8.397
2014-15	592000	453075	5799353	-76707	8.305
2015-16	585000	440608	4566630	-76092	7.786
2016-17: RE	582000	406708	4943644*	51424*	7.006*
2017-18: BE	580000	423226	-	-	-

Source: Union Budgets, RBI, CCIL & Researcher's Work

(April – February 2016)*

However, meager allocation (Rs 10,000 crore) for the PSU Bank's recapitalization appears disappointing despite sharp rise in deposits after demonetization. However the 1 percentage point rise in provisioning for NPA gives some relief to banking industry due to its lower tax liability linkages, though lending constraints are still a big drag behind slower credit growth.



Despite robust macro-economic stability, the disinvestment target including strategic disinvestment appears overestimated given the preceding years' performance averaging around 69.86% (5-year average) of the budget estimate. For FY18, the government proposed total disinvestment target (including strategic disinvestment) of Rs 72,500 crore, 28.3% higher than Rs 56,500 crore (BE) in FY17 and 59.3% higher than Rs 45,500 crore (RE) in FY17. However disinvestment decision would also depend on the performance of stock market for better pricing. Currently stock market is relatively better positioned, but lower real GDP growth expectations (6.75% - 7.5%) in FY18 and global uncertainty related to crude oil pricing, protectionist pressures on global trade and outward pressures on capital flows may keep Indian stock market range-bound.

The budgetary proposal of fiscal deficit profile looks good under all four major fiscal deficit indicators with falling trends, signaling government's adherence to fiscal discipline despite sharp rise in capital expenditure and modest rise in revenue expenditure demonstrating government's success in reducing systemic leakages in social welfare schemes through broadening of the direct benefit transfer net. The government should be given credit for its fiscal management approach particularly on front of slower growth in subsidy and reduction in systemic leakages.

Table-02: India's Deficit Profile (as % of GDP)					
F-Year	**Primary Deficit**	**Revenue Deficit**	**Effective Revenue Deficit**	**Fiscal Deficit**	**Current Account Deficit**
2011-12	2.70	4.40	2.90	5.70	4.20
2012-13	1.80	3.60	2.50	4.80	4.80
2013-14	1.10	3.10	2.00	4.40	1.70
2014-15	0.90	2.90	1.90	4.10	1.30
2015-16	0.70	2.50	1.60	3.90	1.20
2016-17: RE	0.30	2.10	0.90	3.50	1.00
2017-18: BE	0.10	1.90	0.70	3.20	-
Source: Union Budgets & RBI					

Intuitively prudent fiscal policy and sustainable debt path is the principal macro-economic anchor of the overall economy. In proposed budget, the government sticks to fiscal prudency albeit with a marginal rise (0.2%) in fiscal deficit / GDP ratio to 3.2% in FY18 against mandated 3.0% under the FRBMA. However, the government should be given credit for its fiscal discipline, provided intensified uncertainty in domestic economy (over demonetization impact, lower capital inflows expectation) and global economy (quicker hike in the US Fed Rate on account of rising inflationary pressure; uncertainty around commodity prices and protectionist pressures on global trade). These uncertainties with sluggish private sector investment and higher public expenditure may generate upward risk in fiscal discipline and consequently make fiscal deficit target little bit doubtful. The same can be observed from government's escape clause under assumption of 'far-reaching structural reforms in the economy for deviation of 0.5% from stipulated fiscal target for next three years – which can be interpreted as risk factor of unanticipated fiscal implications including macroeconomic conditions and political scenario in the coming years.

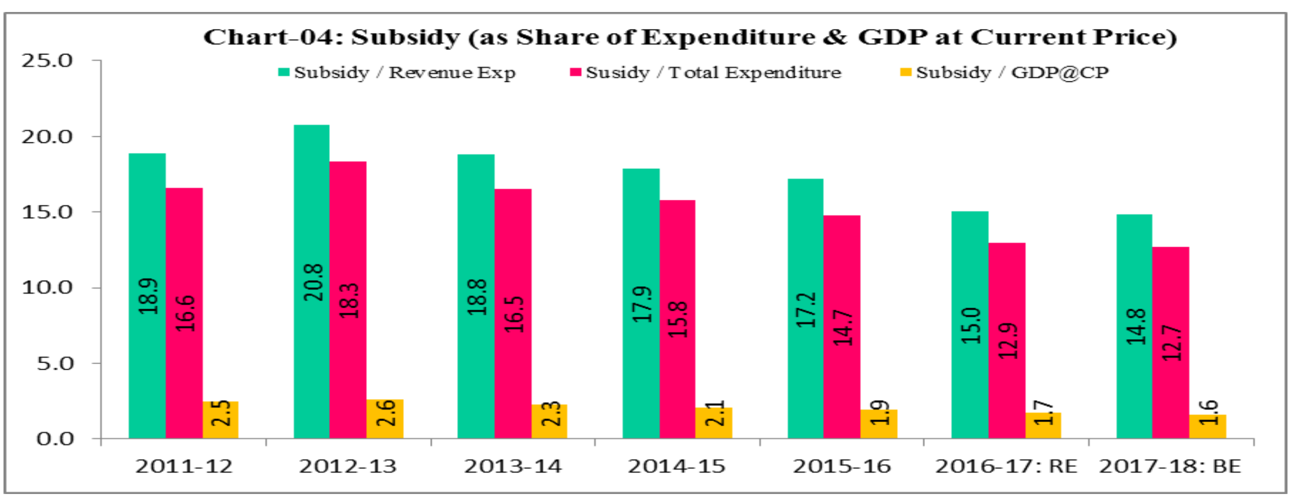
In the proposed budget, the overall subsidy is projected to grow 4.53% largely due to rising pressure from food subsidy – which is expected to grow at 7.52% despite good harvest and lower food prices. Although the government succeeded in keeping fertilizer subsidy with its budgetary target by making fertilizer 'Neem-coated Urea' and limiting its leakage to industrial production, the expectation of lower petroleum subsidy (-9.2% to Rs 25000 crore) is less likely due to rising crude oil prices and sensitivity to complete pass-through to end-consumers under political pressures. With growing coverage of National Food Security programme across different states, the food subsidy appears under-estimated and also depends on progress of monsoon next year. However any improvement in the direct benefit transfer on this account may keep the food subsidy target within achievable range.

Table-03: India's Subsidy Profile (Rs Crore)

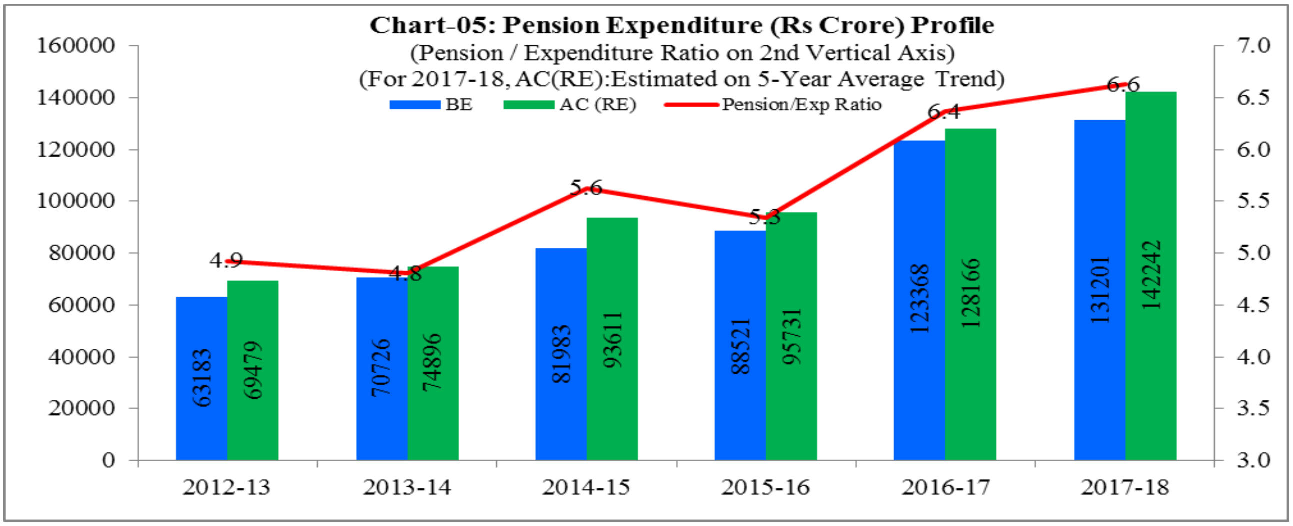
F-Year	Food	Fertilizer	Petroleum	Interest	Misc.	Total
2011-12	72823	67199	68481	5791	2002	216297
2012-13	85000	65974	96880	7968	2493	258315
2013-14	92000	67339	85378	8137	5148	258002
2014-15	117671	71076	60269	7632	5634	262282
2015-16	139419	72415	29999	16730	5542	264106
2016-17 : RE	135173	70000	27532	19425	8356	260485
2017-18 : BE	145339	70000	25000	23204	8733	272276

Source: Union Budgets

Other ratio measures of the subsidy profiling – Subsidy/Revenue Expenditure, Subsidy/Expenditure, Subsidy/GDP@CP (current price) show significant contraction in the overall subsidy in last five years, showing decline in systemic leakage in fertilizer subsidy and food subsidy and complete pass-through of petrol/diesel prices to consumers apart from holding benefits of lower crude oil prices in the current fiscal year. Despite further expansion in providing subsidized LPG (cooking gas) connection to poor households, the trend decline signals better subsidy management.

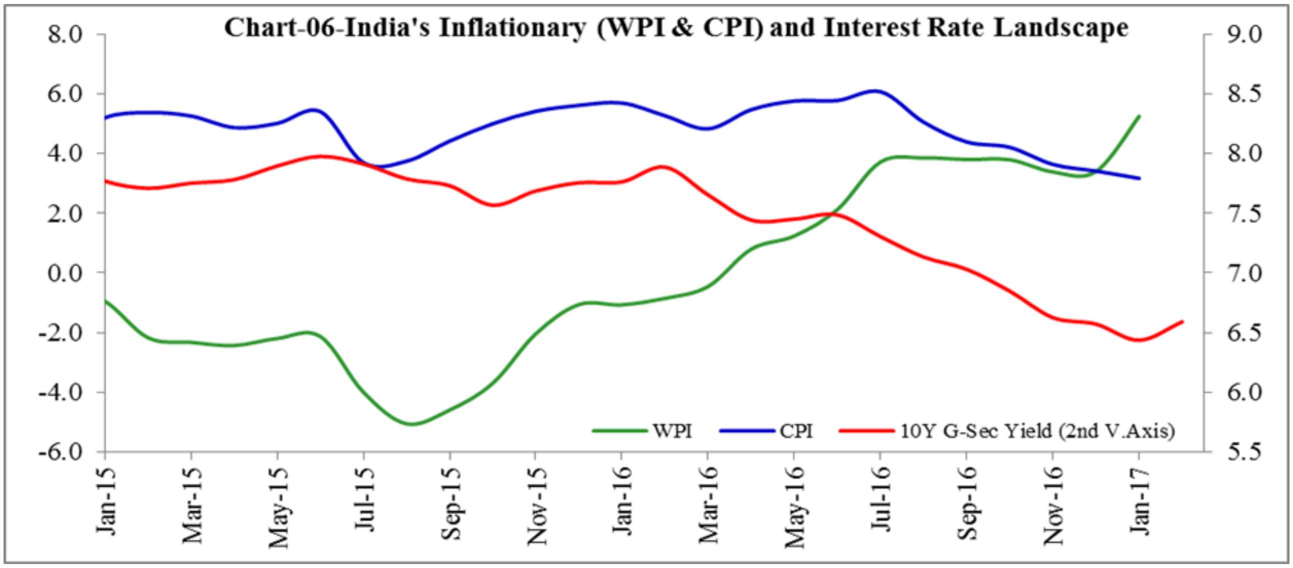


Another pressure on central government's fiscal position arises from sharp rise in pension allocation covering increasing pensioners on scale (rise in pension under OROP) and scope (wider pensioned society). In the FY17, the pension allocation rose hugely by 33.9% to Rs 1,28,166 crore (RE) from Rs 95,731 crore in FY16 and 3.9% higher than budgetary allocation of Rs 1,23,368 crore in FY17, indicating first two installment of 'OROP' scheme drove the pension expenditure sharply up.



However, the government's projection of 2.37% higher budgetary allocation to Rs 1,31,201 crore for FY18 seems to be underestimated because of two due installments of OROP and rising scale pressures from revised pay under 7th Pay-commission. The average upward pressures over budgeted estimate in pension expenditure is estimated around 1.08 times higher in last five years. The pension/expenditure ratio (6.6% in FY18 against 6.4% in FY17) displays rising pressure on government's expenditure.

India's current inflationary (CPI) outlook is stable and comfortable (around 3-year low of 3.17% in January'17) within the target range of monetary policy. However, this easing of inflationary pressure was largely attributed to lower food prices and weaker sentiment in housing sector. But the sharp rise in WPI inflation in recent months (a 30-month high of 5.25% in January'17, after a 17-month stay in deflationary domain) is sufficiently signaling the possibility of sharp upward pressure in the CPI inflation in coming months.



This expectation may also transmit to interest rates in coming months, reflecting from the recent rise in 10-year benchmark G-Sec yield by around 45 basis points in February'17. Any pick up in global risk profile may further put upward pressures on the interest rate trajectory. The divergent trajectories of WPI inflation and CPI inflation in January 2017 strengthens signals of bottoming out possibility of lower CPI inflationary and higher inflationary expectation ahead. The RBI's change in its policy stance from accommodative to neutral (rationalizing on rising overall global risk profile and possibility of upward pressures on inflationary expectation (4.5% - 5.0% in H1:FY18) in coming quarters), also affirms the same. In that scenario with objectivity of inflation targeting, any rise in Indian monetary policy rate in near term is less likely, but can't be neglected completely towards the end of 2017-18.

The government proposed further liberalization of FDI policy through structural reforms includes abolition of Foreign Investment Promotion Board (FIPB) and integration of spot market and derivatives market in the agricultural sector for commodities trading. A mechanism of streamline institutional arrangements for resolution of disputes in infrastructure related to construction contracts, PPP and public utility contracts. The budget also proposes exemption of foreign portfolio investor (FPI – Category I & II) from indirect transfer provision, but kept redemption of share or interest rate outside this provision.

With objective of further pursuance of digital economy, the government restricted cash transactions up to Rs 3 Lakh and above this amount, only digital mode of transaction would be permitted. The government is also promoting usage of BHIM Application for fund transfer / payment through incentivizing Referral Bonus Scheme for individuals and a Cash-back Scheme for merchants. The government proposes to set a target of 2500 crore digital transaction for FY18 through other digital modes including UPI, USSD, Aadhar Pay, IMPS and debit cards. The government also proposes lower income consideration for medium tax payers (with business turnover up to Rs 2 crore) at 6% (against 8% of total cash turnover) in case of digital transactions. To strengthen payment infrastructure and keep transaction transparency, the government proposes to create a Payments Regulatory Board in the RBI by replacing the existing Regulatory Board for Payment and Settlement Systems.

The Union Budget 2017-18 looks a good balance between resources and constraints provided stable and sound domestic macroeconomic conditions and discounting short-term external risk. The greater emphasis on recovery and revival of rural economy through basic infrastructure developments like road connectivity, rural housing clusters, time-bound electrification of rural villages and providing drinkable water through pipelines is one of its biggest takeaways. Although this proposal has capacity of massive job creation and improving rural livelihood along with limitation over migration, the expectation of positivity depends on rational and faster implementation of these programme.

Another positive part of budgetary presentation is about electoral funding reforms: maximum cash donation of Rs 2000/- per person, proposal of amending RBI act to enable the issuance of electoral bonds and filing of Income Tax-return within the prescribed time (if implemented successfully, would bring transparency in socio-politico life) and hence improve policy effectiveness. Another major proposal of the budget was removal of plan and non-plan classification of expenditure profile that facilitates a holistic view of fund allocation.

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Market Watch

The Dual Chinese Currency

Yash Dabriwal

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Chinese currency is traded in 2 separate markets - the onshore renminbi (CNY) market and the offshore renminbi (CNH) market. While the CNY market is largely regulated by the Chinese central bank, the rates in the CNH market are primarily driven by market forces of demand and supply. But, with the enormous influence of the Chinese central bank globally, both rates tend to be very close. The gap has been narrowing.

Figure 1 - Rates as of 17 March 2017 – Source: Investing.com

Figure 2 - USD/CNH ; USD/CNY - Source: Bloomberg.com

As clearly evident from the charts, through a major portion of 2016, the CNH was weaker than CNY indicating betting on weaker Chinese currency by the traders internationally. This trend has now reversed. This reversal seems to be caused by the attempts of the Chinese Central bank (People's Bank of China) to reduce money outflow from the economy. The liquidity in the CNH market has also shrunk, and hence we see volatility in the rates evident from the swings above and below 1.

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The Euro Conundrum

Vedant Bagry

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Ideally, when the German Government Bond yield increases and the yield differential with the US Government Bond reduces, the demand for Euro should increase. This increased demand should lead to the appreciation of Euro against the USD. But not this time around!

US Govt 10Y yield US Govt 10Y yield

USD/EUR

The depreciation in Euro can be attributed majorly to Brexit and fear over the future of the Euro Zone with other nations lining up to exit. These turbulent times are making some historical relationships unreliable, and speculation even more challenging.

Data Source: Bloomberg.com

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