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India: Eco packages 4.0 and 5.0 aim for structural reforms and privatization

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On May 16th and 17th, the Finance Minister provided details regarding the fourth and the final fifth tranche of the INR20trn (10% of GDP) stimulus package that PM Modi announced on 12th May (see details of the first, second and third tranches here, here and here). In this report, we discuss the measures announced in the 4th and 5th tranches and also provide an overall view regarding the INR20trn stimulus package. Key observations:

* The breakup of the stimulus package is as follows. The Finance Minister announced INR11trn worth of packages through 5 tranches, which, along with previous fiscal relief measures (INR1.9trn) and RBI liquidity support (INR8.0trn) add up to a total of INR20.97trn. However, **the actual fiscal impact (increased on-budget spending) of the overall stimulus package of INR20.97trn** (10.5% of DB nominal GDP estimate; 9.3% of FY21 nominal GDP estimate provided in the budget) **is only 1.0-1.2% of GDP**, which will increase the overall fiscal deficit to about 4.5% of GDP, from FY21 budget estimate of 3.5% of GDP, ceteris paribus. The remaining stimulus measures are in the form of subsidized loans, credit guarantees, liquidity support from RBI, contingent liabilities etc. which will not have a bearing on the fiscal deficit dynamic for FY21, though in some cases it can increase the level of public sector debt/GDP (DB estimate: 80.9% in FY21, up from a likely 70% outturn in FY20).

* **1% of GDP worth additional spending is not sufficient to support the ongoing destruction in domestic demand**, and more direct fiscal support will be required through the course of the year to support growth, in our view. **We anticipate 0.8-1.0% of GDP in additional expenditure to be announced during the course of the year** (most likely in 2HFY21), which will push the total fiscal support to about 2% of GDP. We have factored in about 2% of GDP worth of revenue losses (tax + non-tax + disinvestments) and, along with an additional 50bps hit due to an expected collapse in nominal GDP growth (DB estimate: -1.5%yoy), the **total fiscal deficit of the centre will likely rise to about 8% of GDP.** We have factored in about 4.5% of GDP combined fiscal deficit of states for FY21 (the centre has now allowed states' borrowing to potentially rise to about 5% of GDP, subject to some conditionalities), which may push up **the general government budget deficit to about 12.5% of GDP. Given the lack of strong fiscal support, we continue to forecast a 5.5%yoy contraction in real GDP during FY21 and expect a shallow recovery thereafter in FY22 (DB estimate: 6.2%yoy real GDP growth).**

* A number of measures announced over the last few days include growth-critical **structural reforms** (particularly in the agricultural sector) and a strategy to push for **privatization**, but the positive impact of these will likely fructify only over the medium to long term, **leaving the current problem of weak aggregate demand largely unaddressed.**

* Most of the measures announced would require banks to ramp up credit growth expeditiously for supporting MSMEs, NBFCs, the housing sector, farmers etc. and as in the past **execution remains a key risk**, particularly in the current period, when financial institutions themselves have weak balance sheets and are working with limited on-site staff due to the ongoing nationwide lockdown.

* **Recapitalisation of public sector banks may become necessary,** in our view, as NPA's rise in the near future, can potentially add to the future fiscal deficit and public debt (depending on the nature of capital infusion: cash vs. bonds).

* With fiscal stimulus not being that strong, **we expect the RBI to continue to provide support through conventional and unconventional measures.** We expect: i) 75bps repo and reverse repo cut; ii) more regulatory forbearances and extension on loan moratorium period; iii) large OMO purchases or/and purchases of government bonds in primary market; iv) introduction of a Standing Deposit Facility (SDF) – 50 or 100bps lower than the reverse repo rate – to push market interest rates lower; and v) measures to prevent banks from deploying large amount of surplus liquidity at RBI's reverse repo window at the current rate of 3.75% (so as to force banks to deploy the surplus liquidity either by buying government or/and corporate bonds or to lend out such funds to the productive sectors of the economy).

Figure 1: Details of the overall stimulus package

Liquidity and fiscal relief measures	INR trn
Tranche 1 Economic package (13 May'20)	5.9
Tranche 2 Economic package (14 May'20)	3.1
Tranche 3 Economic package (15 May'20)	1.5
Tranche 4 & 5 Economic package (16 May and 17 May'20)	0.5
Total amount (Tranche 1 to 5)	**11.0**
Earlier measures including PMGKP	1.9
RBI measures (actual)	8.0
Total amount (earlier measures)	**9.9**
Grand total	**21.0**

Source : Ministry of Finance and Deutsche Bank

First, we discuss the details of the 5th tranche announced on 17th May followed by the reform measures announced on 16th May as part of the 4th tranche.

17th May announcement (5th and final tranche)

The 17th May announcement covered 7 areas: 1) MGNREGA (rural employment guarantee scheme); 2) health and education; 3) businesses; 4) de-criminalisation of Companies Act; 5) ease of doing business; 6) public sector enterprises; and 7) resources related to states. **We highlight four key announcements:**

* **The first key announcement was related to the rural employment guarantee scheme**. Allocation for NREGA was increased by an additional INR400bn over and above the INR610bn budget estimate for FY21. **This will increase on-budget spending by INR400bn and add to the fiscal deficit.**

* **The second key announcement was related to allowing private sector participation in all sectors, except in strategic sectors involving public interest.** A new public sector enterprise policy will be announced soon, providing list of strategic sectors requiring the presence of public sector enterprises (PSEs) in public interest. In strategic sectors, at least one enterprise will remain in the public sector but the private sector will also be allowed. **In other sectors, PSEs will be privatised (timing to be based on feasibility).**

The decision to allow greater private participation in most sectors is positive for the economy over the medium to long term, but is unlikely to have any bearing on the short-term macro dynamic. The private corporate sector is already under severe stress due to the adverse impact of Covid-19 and its profitability will remain muted for a long time, even after the nationwide lockdown is lifted. In this backdrop, and given the highly uncertain outlook, private sector corporates will likely find it challenging to increase their business size and investments anytime soon, even with the government opening up the possibility for greater participation. Additionally, while increased private sector participation in different sectors will increase competition and productivity, it will also mean further consolidation along with the need for cost and jobs rationalisation, which is likely to be opposed by various Trade Union bodies, in our view.

* **The third key announcement was related to an increase in the state government borrowing limit.** Given requests from various states, **the centre now has decided to increase the borrowing ceiling from the existing 3% to 5% of GDP. This will potentially allow an additional INR4.28trn of borrowing to take place and help states to manage their finances. The increase in the states' borrowing limit, however, comes with riders beyond a particular threshold.** The first increase in the borrowing limit of 0.50% of GDP will be unconditional. But the next 1% of GDP increase in the borrowing limit will be delivered in four tranches of 0.25% of GDP, with each tranche linked to clearly specified, measurable and feasible reform actions. The last 0.5% of GDP extra borrowing limit will only be allowed if milestones are achieved in at least three out of four reform areas (which include: 1) "one nation one card", 2) ease of doing business, 3) power distribution and 4) urban local body revenues).

The states' fiscal position has weakened significantly and fiscal deficit and market borrowing is bound to go up in FY21. In this backdrop, the increase in market borrowing limits is along expected lines. However, **permission for additional borrowing beyond 3.5% of GDP comes with riders and, if those conditions are not met, then state governments which are faced with higher fiscal deficits due to a bigger revenue collapse, may have no choice but to reduce expenditure significantly to manage the fiscal deficit at 3.5% of GDP, leading to an adverse impact on growth.**

* **It was also announced that debt related to Covid-19 will not be considered as "default"** under Insolvency and Bankruptcy Code (IBC) and that no fresh insolvency procedure under IBC will be initiated up to 1 year. **However, the timeline and**

definition of Covid-19-related debt was not spelt out, which will be notified later.

17th May announcement (5th and final tranche)

1. MGNREGA (Rural Employment Guarantee Scheme)

FY21 budget estimate for rural employment guarantee scheme was INR610bn. **An additional INR400bn will be allocated.**

2. Health and education

Public expenditure on health will be increased. Public health labs to be increased at all block levels. All districts to have "infectious disease block" in their hospitals. Extra allocation for health related expenditure was not disclosed.

One committed TV Channel per class for class 1 -12 students will be started.

3. Businesses and Covid-19

Debt related to Covid-19 will not be considered as "default" under Insolvency and Bankruptcy Code (IBC). No fresh insolvency procedure under IBC will be initiated upto 1 year. For MSMEs, special insolvency framework will be notified under Section 240A of IBC. Additionally, minimum threshold to initiate insolvency proceedings for MSMEs to be raised from INR1lakh to INR1crore.

4. Decriminalisation of Companies Act defaults

To decriminalise minor violations of Companies Act. To drop 7 compoundable offences from Companies Act. Ordinance to amend Companies Act to relax rules to be announced soon. The amendments will de-clog the criminal courts and NCLT.

5. Ease of doing business for corporates

Direct listing of securities by Indian public companies in permissible foreign jurisdictions. Private companies which list NCD's on stock exchanges not to be regarded as listed companies.

6. Public sector enterprises

Private sector will be allowed to participate in all sectors. A new public sector enterprise policy in this regard to be announced soon. List of strategic sectors requiring presence of public sector enterprises (PSEs) in public interest to be notified. In strategic sectors, at least one enterprise will remain in the public sector but private sector will also be allowed. In other sectors, PSEs will be privatised (timing to be based on feasibility etc.).

7. Resources related to states

Advance release of the INR110.92bn state disaster fund has been made to states in April. Revenue deficit grants of INR123.9 was given to states on time over April and May. States have borrowed only 14% of the authorised limit till now (INR6.14trn borrowing allowed which is 3% of GDP). Given requests from various states, **the centre now has decided to increase the borrowing ceiling by 200bps to 5% of GDP. This will potentially allow additional INR4.28trn in borrowing to take place and help states to manage their finances.**

The increase in the states' borrowing limit however comes with riders beyond a particular threshold. The first increase in the borrowing limit of 0.50% of GDP will be unconditional. But the next 1% of GDP increase in the borrowing limit will be delivered in four tranches of 0.25% of GDP, with each tranche linked to clearly specified, measurable and feasible reform actions. The last 0.5% of GDP extra borrowing limit will only be allowed if milestones are achieved in at least three out of four reform areas (which include: 1) "one nation one card", 2) ease of doing business, 3) power distribution and 4) urban local body revenues).

16th May announcement (4th tranche)

The 16th May announcement was related to structural reforms for 8 sectors which are aimed at fast tracking investments, thereby boosting growth, productivity and job creation. **The decision to end the government monopoly in the coal sector by inviting private participation in commercial mining and increasing the FDI limit for defence manufacturing to 74% from 49%** were two key measures announced in the fourth tranche (16th May), but these measures are likely to have a beneficial impact only over the medium to long term, in our view. That also holds true **for the minerals sector where it has been decided to enhance private sector investments.** While these measures are definitely positive, it is worth noting that there are structural issues related to land acquisition and forest department clearance, which need to be handled at the state government level and any delay on those fronts or lack of active cooperation from the states, may prevent the reforms from attaining their full potential. In short, **execution remains the key risk, as in the case of many other measures, which have been announced in the last few days.**

Additionally, to give a further push to the Make-in-India initiative and generally make India more self-reliant related to its defence equipment capabilities, it was announced that **imports of certain weapons and defence platforms (list of items will be notified) will be banned. The import bill related to defence is expected to come down as a result of this.**

Surprisingly, no relief package was announced for the aviation sector, that has been impacted severely due to Covid-19, though decision related to rationalisation of air space and **intention of making India a global hub for aircraft maintenance, are likely to have benefits over the medium to long term.**

Overall, the structural reforms unveiled in the 4th tranche (16th May) are all long-term oriented and will have **no bearing on the current year's fiscal dynamic or boosting near-term aggregate demand** that has been affected significantly due to the extended nationwide lockdown to combat Covid-19.

Structural reforms announced related to 8 sectors are as follows:

Coal sector

1. To bring in commercial mining in the coal sector on a revenue sharing basis with

the objective of increasing self reliance related to coal production. The opening up of the sector from the earlier government monopoly is likely to boost coal availability. **INR500bn will be allocated for coal evacuation infrastructure.** Coal bed methane (CBD) extraction is likely to happen through auctions now. To incentivise coal gasification via rebate in revenue share.

Minerals sector

1. **To enhance private investment in minerals mining sector.** 500 mining blocks to be offered through an open and transparent auction process. To remove distinction between captive and non-captive mines. A mineral index will be set up and stamp duty will be rationalised at the time of award of mining leases. Joint auction of bauxite and coal to be conducted.

Defence production

1. **Imports of certain weapons and defence platforms (list of items will be notified) will be banned** to boost the make-in-India initiative. Import bill related to defence will come down as a result of this.

2. **To corporatise (not privatise) ordinance factory board.** Ordinance factory board is likely to become more efficient and transparent. Can look at listing ordinance factory board on stock exchanges.

3. FDI limit for defence manufacturing to be increased to 74% from 49%.

Civil aviation

1. Restrictions on utilisation of Indian air space will be eased (currently, only 60% of Indian airspace is freely available). Rationalisation of air space will help to reduce flying time and cost. Expected to bring in benefits of about INR10bn per year.

2. 6 more airports identified for 2nd round; bidding process to commence immediately. Airports Authority of India to get down payment of **INR23bn** and first and second round of investment in 12 airports will get **INR130bn.**

3. To make India a global hub for aircraft maintenance.

Power sector

1. Power distribution companies in the Union Territories to be privatised. Standard of services likely to improve with privatisation.

Social infrastructure

1. For the creation of social infrastructure projects, the central government has made a provision of INR81bn which will be in the form of viability gap funding (30% from central government vs. 20% earlier).

Space

1. **To boost private participation in the space sector.** To allow private sector to use ISRO's facilities to boost private space exploration. Government looking at a liberal geospatial data policy.

Atomic energy

1. To have a PPP model research reactor to make medical isotopes.

Appendix 1

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Backtested, hypothetical or simulated performance results have inherent limitations. Unlike an actual performance record based on trading actual client portfolios, simulated results are achieved by means of the retroactive application of a backtested model itself designed with the benefit of hindsight. Taking into account historical events the backtesting of performance also differs from actual account performance because an actual investment strategy may be adjusted any time, for any reason, including a response to material, economic or market factors. The backtested performance includes hypothetical results that do not reflect the reinvestment of dividends and other earnings or the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid. No representation is made that any trading strategy or account will or is likely to achieve profits or losses similar to those shown. Alternative modeling techniques or assumptions might produce significantly different results and prove to be more appropriate. Past hypothetical backtest results are neither an indicator nor guarantee of future returns. Actual results will vary, perhaps materially, from the analysis.

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