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PNB GILTS LTD (Subsidiary of Punjab National Bank)

ECONOMY & GILT WATCH

Deficit Monetization: Will RBI take the plunge?

The last few weeks saw the RBI and the government take unprecedented measures in order to combat the Covid crisis which has turned into a full blown economic crisis as the containment measures deal a death blow to the domestic economy. RBI has taken strong measures on all counts, interest rates, liquidity and regulatory in order to offset the disruption caused by the crisis in the financial sector and markets. Equity markets have regained confidence and have recouped from the lows seen in last week of March. However, bond markets are not particularly enthralled despite the substantial steps taken on liquidity and interest rate front. The 10-yr yield rose sharply touching a high of 6.50% in the last fortnight on concerns of heavy government borrowing at both Centre and State level. The recent developments in the market and the anticipation of government finances coming under stress have raised the clamour of RBI funding the deficit directly through monetization.

Budgeting exercise gone in vain

The Covid crisis has turned the tables for the Indian economy with dynamics changing substantially in a matter of few weeks and with this the budgeting done for the year may have lost its relevance completely. The containment measures is destroying jobs across sectors, with the informal sector which is the largest employer being hit hardest. The government finances will remain under duress as the revenues take a sharp hit while massive welfare measures need to be undertaken in order to provide basic necessities to the population. The state finances are expected to take a sharper hit compared to center as transactions such as transport fuel, vehicle sales, real estate transactions etc, which are the main sources of revenue have come to a grinding halt. The states have already been allowed to raise Rs. 3.2 trillion in

INSIDE THE ISSUE

the first nine months of the ongoing financial year, which is 50% of the net borrowing limit. Markets were quick to react to the growing concerns of state debt becoming unsustainable and demanded sharply higher coupons in the last SDL issuances. The position of the Center finance is also somewhat precarious, as tax revenues which had been projected rather optimistically will take a sharp hit as economic growth stalls, while disinvestment target of Rs. 2.1 trillion also looks far-fetched in the current scenario. The budget numbers certainly need a relook and a re-allocation of resources needs to be worked out in order to address the ongoing crisis as well as base the budget workings on more realistic projections of growth & revenue.

Will RBI Oblige?

Indeed the conditions are unprecedented and RBI has compared them to nothing less than being in a war. World over, Central Banks have undertaken extraordinary measures to support the economies. The Bank of England has announced the temporary reactivation of a scheme that makes it possible for the central bank to finance public spending directly while US has embarked on an unlimited Quantitative Easing program even adding junk bonds to the list of assets it can buy. Back home, RBI has relaxed the WMA limits for both center and state governments, however the same shall only take care of short term cash flow mismatches. The issue of long term financing remains unaddressed and there is a growing expectation that RBI may need to expand further in its role and fund the government deficit directly, or conduct direct monetization of the deficit. RBI is already indirectly monetizing the government deficit through Open Market Operations and is expected to further step up the scale of such operations substantially in order to keep the appetite for bonds alive at a flatter yield curve in the market. Though one may argue that a dampened credit off take and flush liquidity in the system may induce demand for bonds, the rise in cost of borrowing for the government (which is highly plausible in case of heavy borrowings) becomes an impediment in course of monetary transmission in the economy, which RBI had been targeting for a long time now. Whether RBI continues to conduct OMOs and absorb the bond supply on a large scale or it conducts part monetization of the deficit, is something that will depend immensely on market dynamics. A fragmented market and rising operational issues may force RBI to consider the latter. However, monetization of deficit comes with risk of flaring up of inflation in the economy. As per the April Monetary Policy Report, RBI states that inflation scenario remains highly uncertain, even though food prices are on the ebb, the cost push inflation due to supply disruption may pose upward risk to the inflation scenario. Monetization is known to have an unfavorable impact on inflation in the long

run as it leads to an increase in the monetary base. However, RBI may be tempted to throw caution to the wind as it attempts to give the last mile support to the economy in these unprecedented times.

Fixed Income Outlook

Fundamental View

G-sec markets are treading in risky and uncertain territories on concerns of heavy supplies and a likely increase in the borrowing requirement amidst the ongoing crisis. The apprehension was clearly reflected in the auction cut offs of the first Central G-sec and State Development Loan auctions in which the investors sought a yield of 6.53% on the 10-yr paper, while some of the 10-yr SDLs were sold off at a coupon of 8%. Going forward, the state of government finances shall continue to play a key role in determining the market undertone and sentiments may only improve if RBI shows clear intent to play significant role without which it would become difficult for the market to absorb the massive weekly supplies. We expect the 10-yr yield to trade in the range of 6.42% to 6.54% in the coming weeks.

Technical View

6.45% GOI 2029 Yield settled at 6.49% in previous session. Last fortnight, benchmark yield traded volatile and it headed higher above crucial resistance zone of 6.42% zone. Since starting of this month markets have witnessed gap up openings on daily chart, indicating weakening of last three months broader trend.

Momentum indicator RSI is hovering around 58 zone, any sustainability above 60 may take it towards overbought zone. Adding to it, 6.52% zone i.e. 61.8% retracement level of swing high(6.84%)/swing low(5.99%) will act as an immediate resistance on higher side and on lower side 6.42% will act as crucial support zone. From here on, we believe, benchmark yield may consolidate between 6.52% to 6.42% zone for coming days. However, any sustainability above 6.52% may take 10 yr towards 6.66% level and any sustainability below 6.42% will indicate the resumption of downtrend in benchmark yield.

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Chart source: Investing.com

What is Countercyclical Capital Buffer?

In its March monetary policy decision, RBI announced a plethora of measures from, reduction in interest rates, reserve requirements, liquidity infusion and providing forbearance to borrowers. Another relaxation was extension of the implementation timeline of the Countercyclical Capital Buffer or the CCyB for Indian banks.

Background

In response to the Global Financial Crisis of 2007-09, national authorities from all over the world agreed on a new set of rules—collectively known as Basel III—aimed at better regulating the financial system. Besides tweaking the minimum capital requirement, Basel III also introduced new rules that mandate banks to hold extra capital when certain conditions are met. One of these new rules is the so-called CCyB that obliges banks to hold extra capital during periods of "excess aggregate credit growth."

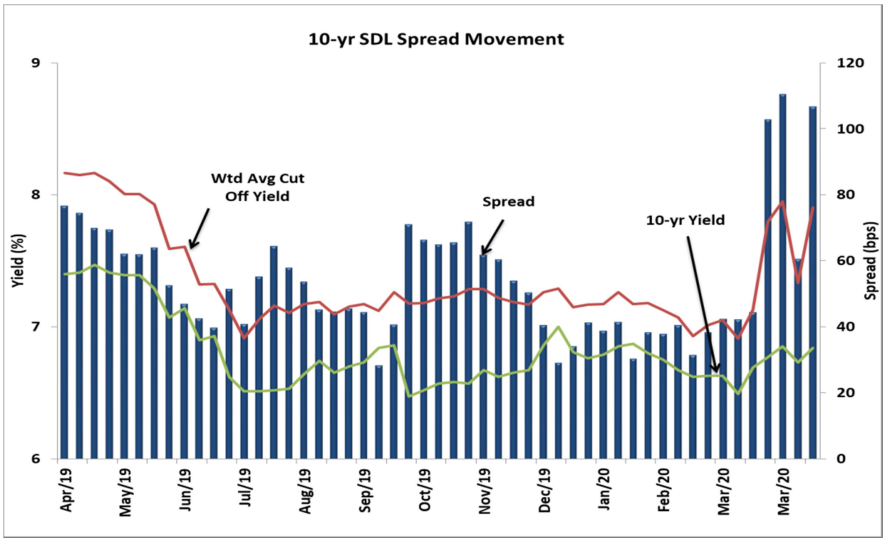
What is the need of CCyB?

A buffer is often used to describe a cushion or protective barrier of some sort, aimed to reduce shock or damage. A countercyclical capital buffer is meant to do just that. By forcing banks to hold proportionally more capital "when their assets grow rapidly (i.e., when the lending business is brisk), regulators can ensure that a larger buffer protects bank solvency should the value of those assets drop at a later point in time. So, at times of downturn in the economy, such buffers may limit the impact of a systemic collapse though it comes at a cost of holding higher capital during good times in the economy.

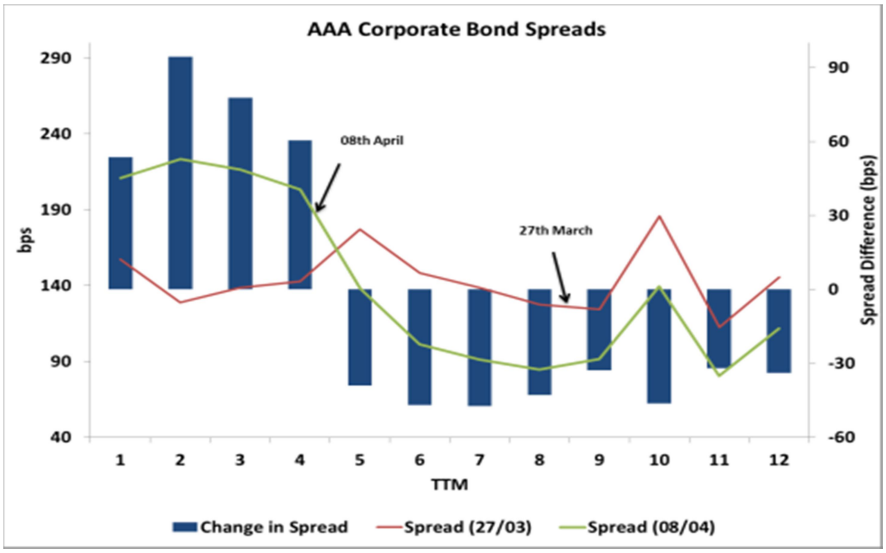
RBI's stance on CCyB

RBI till now has not yet mandated banks to maintain the Capital Conservation Buffer (as the central bank has termed it), even though it has already proposed the implementation of the same. As per Basel standards, the CCB was to be implemented in tranches of 0.625 per cent and the transition to full CCB of 2.5 per cent was set to be completed by March 31, 2019. However, RBI deferred the the implementation of the last tranche of 0.625 per cent of the CCB from March 31, 2019 to March 31, 2020. In the wake of the Covid crisis this timeline has further been extended till September 30, 2020.

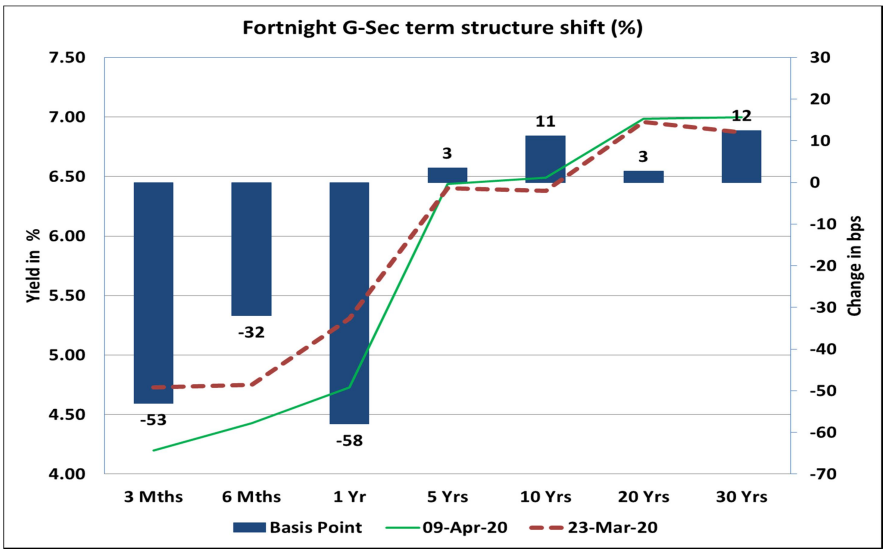
SPREAD MONITOR



As expected, the spreads on SDLs have widened sharply amidst deteriorating outlook of state finances



Short term corporate bond spreads widened during the fortnight



The yield curve continues to display a steepening bias as heavy supplies diminish the demand for G-sec, while short end of the curve continues to see good demand amid surplus liquidity conditions

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