21st September 2020 Vol: 14/2020-21

PNB GILTS LTD
(Subsidiary of Punjab National Bank)

Economy & Gilt Watch

Government Borrowings: Expectations

The government borrowings for the second half of the year shall be announced soon amidst an uncertainty with regard to government finances that has not been witnessed before. Government finances are under duress and poor revenue generation has crippled government's capacity to spend at a time when it was needed most. Though government has restricted stimulus based expenditure to a great extent (~under Rs. 2.5 trillion), the fast deteriorating economic outlook has raised the clamour for a direct fiscal intervention instead of credit based stimulus provided so far. Real GDP growth estimate for FY 2020-21 which was earlier pegged around -5%, is now expected to plunge to -10% to -15% as the pandemic continues to remain resurgent across the country. The fiscal and debt dynamics are fluid and highly uncertain, with the extent of increase in government expenditure and the fiscal deficit contingent on a lot of factors which are hard to predict under the current scenario.

Borrowings set to rise

Anticipating an increased requirement, the government had revised its gross borrowing target for the full FY 2020-21 in the month of May to Rs. 12 trillion from Rs. 7.8 trillion budgeted originally. In the first half of the year, the gross borrowings have been much higher as government continuously mopped up funds by exercising the green shoe option in the weekly auctions. Till the penultimate weekly auction of H1, government had raised Rs. 7.36 trillion (as against budgeted H1 borrowings of Rs. 6.98 trillion), with a considerable Rs. 0.68 trillion being accepted via the green shoe option. It is unlikely that the additionally raised amount of Rs. 0.68 trillion will be adjusted in the borrowings for the second half of the year, as the funding requirements of the government remain high.

Now to what extent the government will further revise its borrowing target will only be known once the calendar is announced. Nonetheless, the trends in the revenue seen till July paint a very grim picture with tax revenue at only 12.4% of the annual budget. On the other hand, no funds have been raised against the disinvestment target of Rs. 2.1 trillion for the year. The additional borrowings of Rs. 4.2 trillion (over and above original budgeted borrowings

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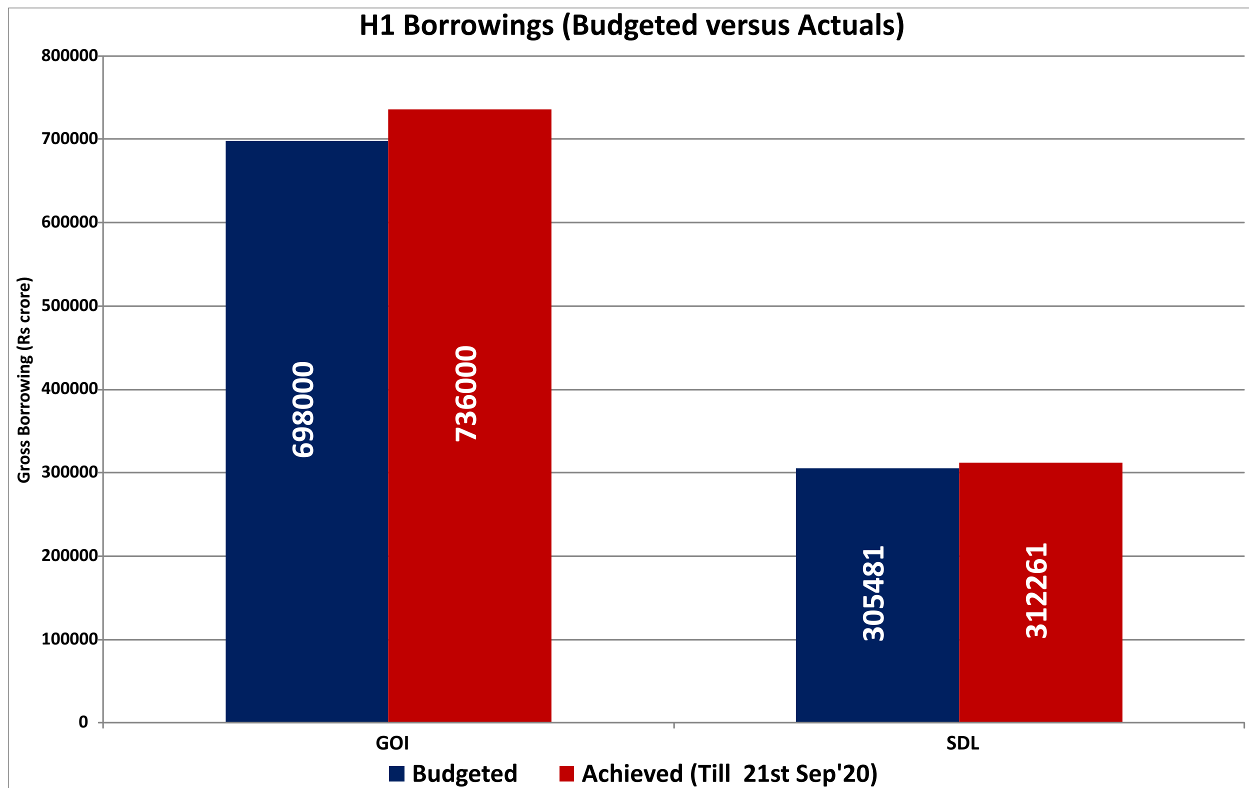
of Rs. 7.8 trillion) are mainly expected to cover up the sharp contraction in tax revenues for FY21. Clearly, government would require additional borrowings to fund the stimulus measures and broadly the borrowings are expected to take a hit of another Rs. 2 -2.5 trillion. Having said that, risks of borrowings taking a sharper hit than that are significantly high as the pressure on the government to dole out a direct fiscal largesse is gradually building up.



State borrowings to add to the supply pain

The pandemic has dealt a body blow to the state government finances as well and the Centre's stance on funding the shortfall in compensation cess through state borrowings shall add up to the supply. As many as 21 states have reportedly chosen "option 1", which allows them to borrow the tax collection shortfall due to the switch to the GST, estimated at Rs. 97,000 crore, by issuing debt under a special window from RBI coordinated by the Finance Ministry. On the other hand, the "option 2" allows states to borrow the entire compensation shortfall of Rs. 2.35 lakh crore, including the shortfall due to coronavirus crisis, by issuing market debt. On the face of it option 1 seems to be less detrimental in terms of supply & the borrowing burden on the states, as Rs. 97000 crore is to be borrowed from the RBI window and does not form a part of the overall state borrowings. On the other hand, option 2 entails a direct increase of Rs. 2.35 trillion in state borrowings. However, on a closer look, states are being offered greater flexibility to borrow under option 1, with considerable unconditional borrowings to the extent of 4% of the GDP. Nonetheless, the state borrowings are going to add to the supply pressure which is already haunting the bond markets and the impact of the same has already started getting reflected in the spreads.

(Rs. Crore)

S.No.	Particulars	Option 1	Option 2
1	Additional Borrowings to meet GST compensation shortfall	97000	235000
2	Compensation cess borrowings as % of GDP*	0.5%	1.3%
3	**Original Borrowing Limit**	**3%**	**3.0%**
4	Additional limit to states under Atmanirbhar Scheme, of which:	2%	2%
4.1	Unconditional borrowing limit	0.5%	1.3%
4.2	Conditional borrowing limit (0.25% for each of the four reforms)	1.0%	1.0%
4.3	Conditional borrowing limit (for meeting atleast three out of four reforms)	-	-
4.4	Additional borrowing limit (incentive to choose option 1)	0.5%	-
5	Total unconditional borrowing limit (3+4.1+4.4)	4.0%	4.3%
6	Overall borrowing Cap	5%	5%
7	Expected State Borrowings (5% of GDP) for FY 2020-21	915293	
8	Gross Borrowings completed in H1	312261	
9	**Expected State Gross Borrowings in H2**	**603032**	

*Assuming 10% contraction over FY 2019-20 nominal GDP (Provisional Actuals at Rs. 203 trillion)
^ Under option 2, unconditional borrowing limit replaced by the compensation cess borrowings of Rs. 2.35 trillion (or ~1.3% of GDP)

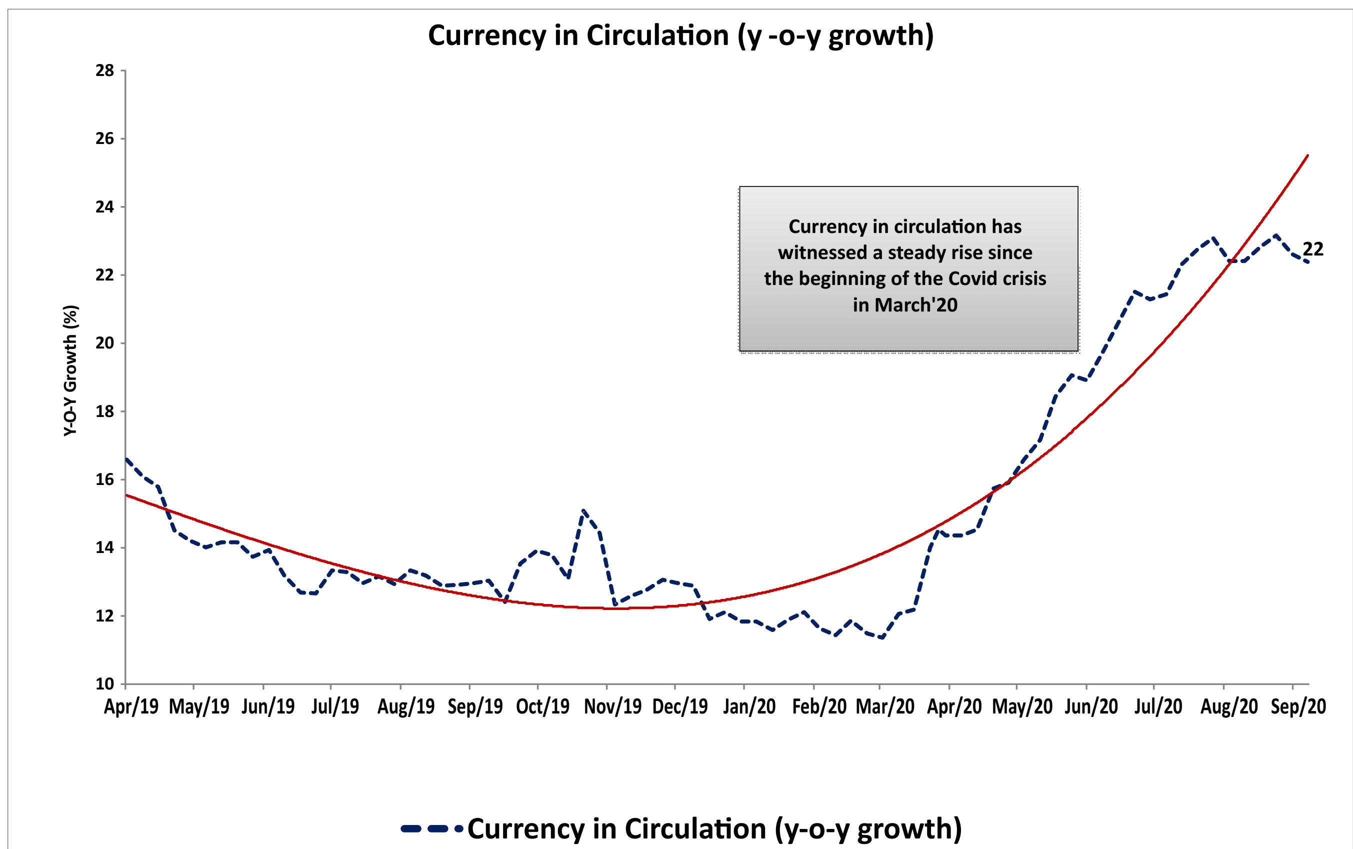
Anchoring the bond markets

In the last few weeks, the bond markets have clearly indicated the discomfort over the supply and RBI had to fully devolve papers in the two of the auctions. RBI was quick in its response to douse the rising tempers in the market by conducting OTs (Rs. 20,000 crore in previous two weeks). RBI has also announced an outright OMO (Rs. 10,000 crore to be conducted on 24th September) as a reduction in surplus liquidity in the previous week on account of unwinding of the outstanding LTROs has opened up space for an outright purchase auction. It would need to be seen, how the market concerns over the forthcoming borrowing schedule for the second half are addressed. RBI has been successful in keeping a cap on yields by giving strong signals, however the absorption of second half borrowings shall entail significant challenge for the central bank and bond markets would look forward to clear signals as far as RBI's support to the borrowing program is concerned.

Macro Monitor

Currency in Circulation grows 10.2% in FY 2020-21

The growth in currency in circulation or CIC continues to stay at elevated levels ever since the Covid crisis hit the economy. On YTD basis, the CIC has grown by a robust 10.2% (till 11th Sep'20) in FY 2020-21as against a rise of 3.1% in the corresponding period of FY 2019-20. On y-o-y basis, CIC growth stood at 22.4% as on 11th Sep'20 as against 13% on the same day last year. A robust increase in currency in circulation is usually corresponds to higher economic activity. However, this does not hold in the current context as the elevated level of CIC is being attributed to public clinging to cash as a precautionary measure. Also, there has been a rise in digital transactions which may also seems to be contributing to this trend.



Fixed Income Outlook

Fundamental View

Bond markets remained largely cautious in the previous fortnight despite special OMO auctions and inflation coming in lower than expected at 6.69% for the month of August'20. Devolvement of the full auction amount in the 10-yr paper in the first auction of the fortnight and bullish cut offs in OMO auctions indicated that RBI intents to keep yields at around the current levels.

In the coming fortnight, two important events are lined up, announcement of the borrowing calendar (at the end of the month) and the monetary policy meet (1st October). While the monetary policy is largely expected to be a non event, with RBI expected to keep the policy rates unchanged, market would keenly await RBI's guidance on inflation and growth trajectory going, which has been missing since the last two policy meets. The borrowing calendar would be keenly watched and any surprises on the calendar, in terms of additional borrowing over and above the scheduled Rs. 12 trillion for the year would be detrimental for the bond markets. In terms of RBI's support to the borrowing program, it is unlikely that the central bank would announce any scheduled calendar for the OMOs and it would continue to conduct OMOs/OTs through regular announcements. In the coming fortnight, we expect the 10-yr yield to trade in the range of 5.90% to 6.05%.

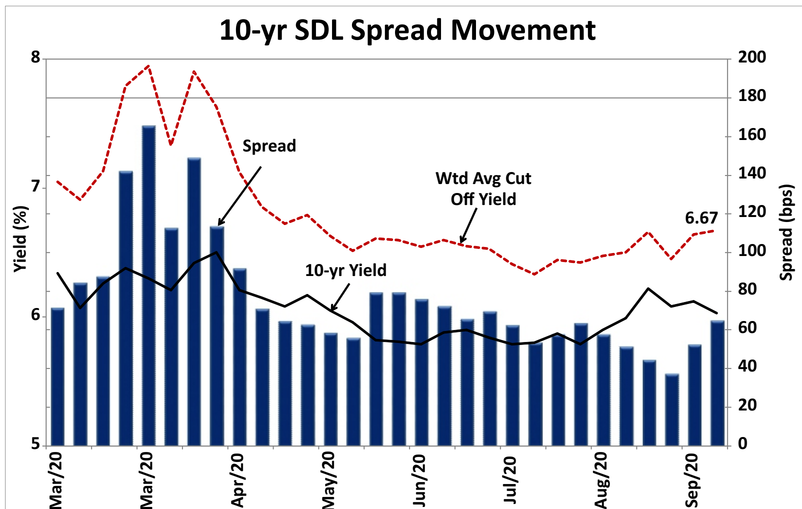
Technical View

5.77% GOI 2030 yield settled at 6.01% on Friday's session. Last fortnight, benchmark yield traded range bound, broadly in range of 5.97% to 6.07%.

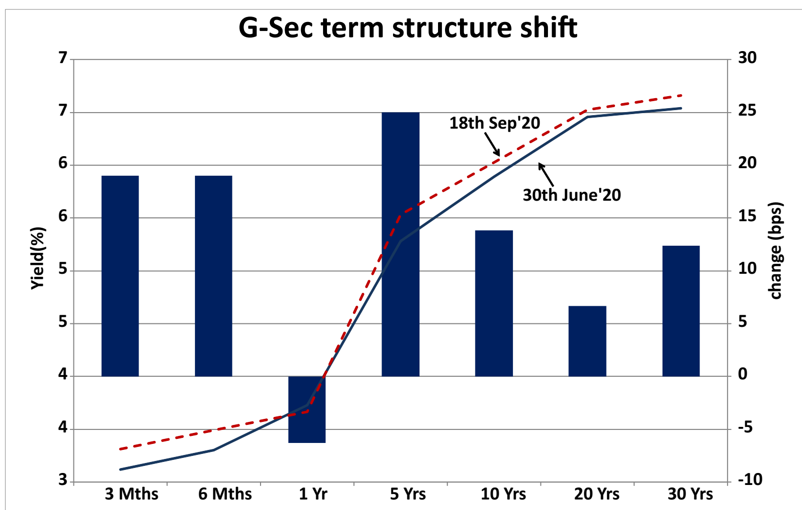
Momentum oscillator RSI is placed at 53 zone. Short term moving average i.e. 30EMA is placed around 5.97% which coincides with immediate support zone, indicating major drift possible only below 5.97%. On higher side Thursday's bullish engulfing candles high i.e. 6.04% will act as crucial resistance area from here on and any closing above 6.03%-6.04% may witness a surge towards 6.10% zone.

Chart source: Ticker Plant

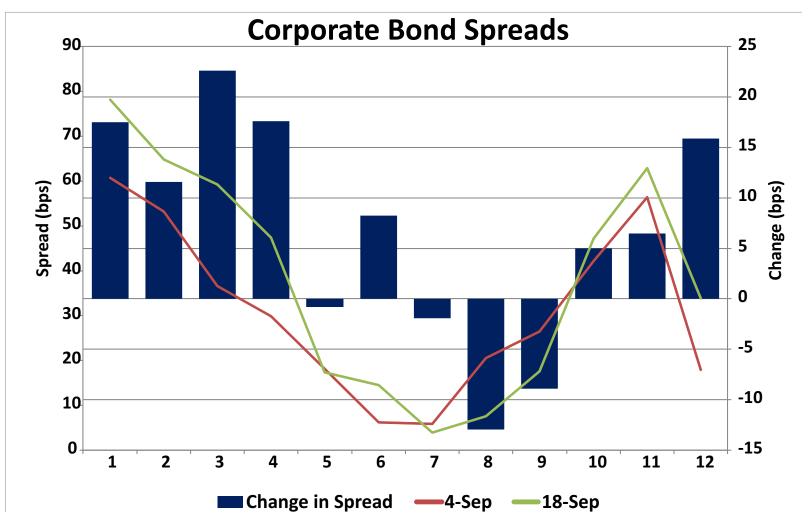
SPREAD MONITOR



SDL spreads are expected to widen given the worsening outlook of state government finances and supply concerns



G-sec yields have inched up with the hardening most pronounced in the 5 year segment



Corporate bond spreads widened during the previous fortnight amidst steady supply at the short end of the curve

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