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PNB GILTS LTD
(Subsidiary of Punjab National Bank)

Economy & Gilt Watch

15th Finance Commission: Striking a Balance

The final report of the 15th Finance Commission for the period FY 2022-26 was tabled in the Parliament on 1st February'21. While much attention was given to the Budget, the Finance Commission report too warrants a thorough analysis as it delves into important details pertaining to state of finance of the Centre and the States in backdrop of the crisis. The impact of the crisis could be seen in the way the debt dynamics of both State as well the Centre changed during the year, and more importantly the fact that the impact would continue to be felt in the coming years too as envisaged by the finance commission report. To begin with, one must note that the Finance Commission is a constitutional body set up every five years, responsible for maintaining the fiscal relationship between the Union and the States (i.e. sharing of revenues between the two) as well as laying down principles for determining the distribution of these revenues amongst various states. The Finance Commission also provides a fiscal roadmap for both Centre and the States, in terms of fiscal deficit to GDP target for the five year period. Lately, the role of the Finance Commission has attracted criticism as the very founding principle of the commission, i.e. cooperative fiscal federalism, seems to have been compromised and tilted in favour of the Centre. Nevertheless, in challenging and uncertain times like these, when the governments face depleting revenues and a heavy expenditure burden, the Finance Commission does have an unenviable job of balancing the requirements at different levels of governments, while ensuring that the ultimate objective of reviving economic growth is met.

Key Highlights

Tax Devolution maintained at 41%

The transfer of revenues from Centre to the States is the single most important theme of Finance Commission recommendation. The transfer of

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funds from the Centre to the States takes place via, i) distribution of taxes or devolution of taxes and ii) grants in aid. The Commission has recommended maintaining the tax devolution or vertical devolution at 41% of the divisible pool of taxes to the States during the five year period of 2021-26. Horizontal devolution criteria, i.e. the criteria determining distribution of the devolved funds amongst various states, factors in the basic principles of expenditure needs, equity and performance by assigning appropriate weights. The 15th FC has introduced two new parameters as part of the horizontal devolution criteria, "demographic performance" and "tax efforts" with weightage of 12.5% and 2.5% respectively, which are intended towards incentivizing better performance by States.

Horizontal Devolution Criteria	14th FC (FY 2016-20)	15th FC (FY 2022-26)
Need Based		
Population	17.50%	15%
Area	15%	15%
Forest & Ecology	7.50%	10%
Equity		
Income Distance	50%	45%
Performance Based		
Demographic Change	10%	-
Demographic Performance (total fertility rate)	-	12.50%
Tax Effort	-	2.50%

Sharp increase in Grants in Aid

While the devolution has been maintained at 41%, the FC has recommended a substantially higher flow of grants in aid from the Centre to the States for the five year period. Broadly, there have been five different types of grants: (a) revenue deficit grants, (b) grants for local govts, (c) grants for disaster management, (d) sector-specific grants and (e) State-specific grants. Except for the revenue deficit grants, these are mostly conditional and performance based. The several categories of grants-in-aid amount to an aggregate of Rs. 10,33,062 crore for the five year period.

(Rs. Lakh crore)

Grants in Aid	14th FC (FY 2016-20)	15th FC (FY 2021-26)	Remarks
Revenue Deficit Grant	1.95	2.95	17 states to receive Revenue Deficit Grant to bridge revenue deficit (unconditional)
Grants to Local Governments	2.87	4.36	All grants (rural & urban bodies, new cities grants) conditional except for health grants of Rs. 70,051 crore
Grants for Disaster Mgmt.	0.55	1.23	Conditional grant for states covered under State Disaster Relief Fund
Sector Specific Grants	-	1.30	Conditional & unconditional grants towards eight sectors (health, education, agri reforms, maintenance of PMGSY, judiciary, statistics, aspirational districts & blocks
State Specific Grants	-	0.50	To be given in areas of social needs, administrative governance & infrastructure, water, sanitation etc .
Total Grants In Aid	**5.37**	**10.33**	

Fiscal Roadmap & Borrowings

With respect to Centre's fiscal deficit, the Commission has recommended a range of possibilities for fiscal and revenue deficit for the Centre for the next five years. While the Commission has recommended a fiscal deficit target of 4% (if the envisaged macroeconomic scenario holds) by FY 2025-26, the Govt. in the annual budget targeted a FD of 4.5% by the end of year 2026. It has also recommended forming a high-powered inter-governmental group to: (i) review the Fiscal Responsibility and Budget Management Act (FRBM), (ii) recommend a new FRBM framework for Centre as well as States, and oversee its implementation.

With respect to State finances, the commission has recommended a higher borrowing limit of 4% of GSDP for FY 2021-22 to offset the impact of slowdown in growth, which would result in lower absolute borrowing limit for states. (The borrowing limit for FY 2021-22 has been decided using average GSDP growth rate observed in FY 2017-18, 2018-19 & 2019-20).

Range of all-State Fiscal Deficit

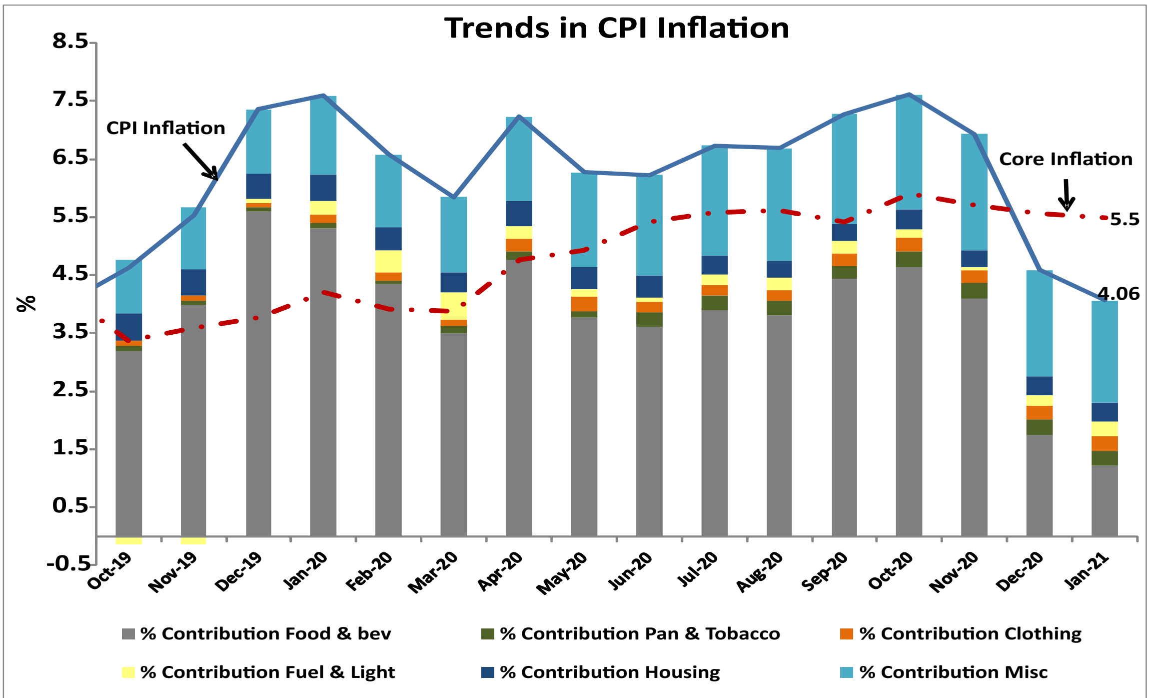
% of GSDP	FY22	FY23	FY24	FY25	FY26
Upper Limit	4.50%	4.00%	3.50%	3.50%	3.00%
Borrowing Limit	4.00%	3.50%	3.00%	3.00%	3.00%
Additional Limit*	0.50%	0.50%	0.50%	0.50%	-
Lower Limit	3.00%	3.00%	3.00%	3.00%	3.00%

*Additional Borrowing limit of 0.50% linked to power sector reforms

Macro Monitor

CPI Inflation Plunges to 4.06% on Softer Food Prices

The headline inflation eased sharply to a 16-month low as prices of key food prices like vegetables plunged sharply in January. However, core inflation continues to remain sticky at 5.50% as cost-push pressures remain rampant in the economy. Inflation faces upside risk as the current flare up in crude oil prices may exacerbate prices pressures in the economy. Further, with the pickup in roll out of Covid vaccination across the globe, the pressure on prices is unlikely to soften from here on. The favourable base effect that also contributed in pushing down the headline number, shall begin to wane out in coming months, which may cause the headline number to inch up again.

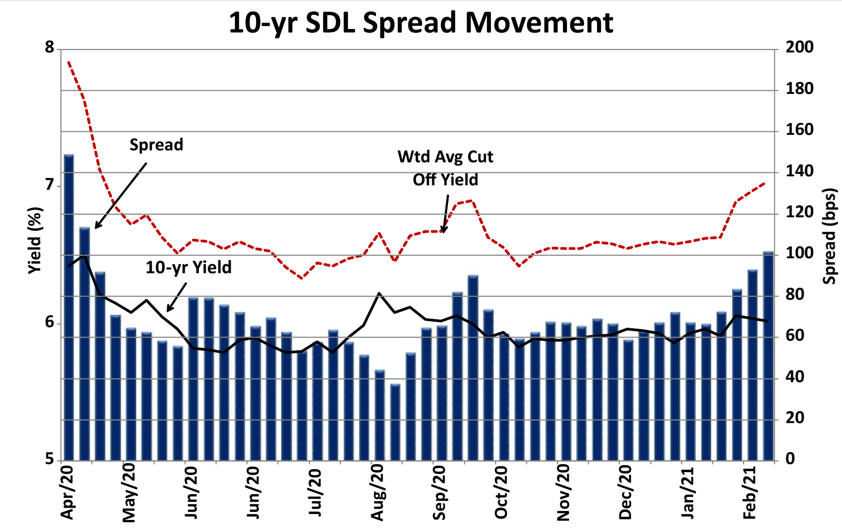


Fixed Income Outlook

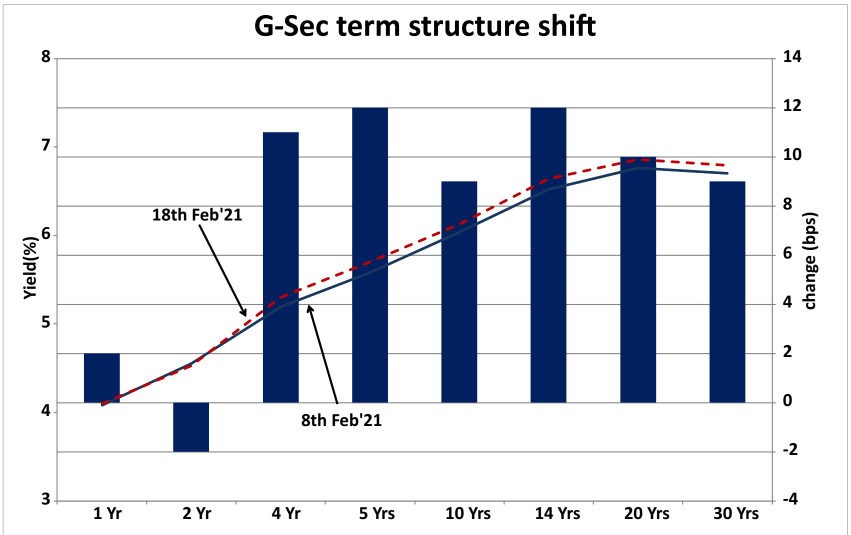
Fundamental View: Continuing from where we left in our last edition, the range of 6.00% to 6.20% on the 10-yr bond can be seen in this fiscal and the upper end of the range can shift upwards in the upcoming fiscal but the lower end of the yield could be seen firmly intact at 6.00%. The lower end of the range was touched during last week on bold and decisive steps taken by RBI. RBI through its direct and indirect interventions reiterated its intent to keep yields well behaved. However, the basic fabric of the market has taken a very different hue after the unanticipated announcement of liquidity withdrawal through the variable reverse repo in early January. The short end of the curve has gone up by 60-80 bps in less than a month which caused major damage to the portfolio construct of investors, hence severely inhibiting their risk appetite. Looking at the overall market, the 10-yr point remains the least damaged because of RBI's efforts with front end of the curve bearing the most severe impact. RBI is expected to do much hand holding and do more untiring efforts to keep the yield curve under control to see that next year's borrowings sail through smoothly. Nonetheless, global factors such as recovering growth, higher commodity prices and higher yields globally are not helping much and under such circumstances efforts by RBI can only slow down the upward movement of yields. Domestically too, factors don't remain much conducive as core inflation remains persistent and faces further upward risk with the recent surge in commodity prices. Hence, a sustained reversal of yields from here does not look plausible as of now. We reiterate the earlier range of the 10-yr yield at 6.00% to 6.20% with an upward bias towards 6.30%

Technical View: 5.77% G Sec 2030 Yield settled at 6.18% on Friday's session. Last fortnight, post a minor pullback, Benchmark Yield resumed its uptrend momentum towards 6.20% zone. Momentum oscillator RSI is placed at 65 zone. As, discussed in last newsletter the trend has shifted from range bound market to bullish in terms of yield and the same was witnessed in passing week. Going forward, yields may try to find a short term top around 6.23%-6.25% level which also coincide with upper Bollinger band level. However, any sustenance and closing above 6.25% level may led to surge towards 6.35% level. On the lower side 6.10% will act as crucial support level.

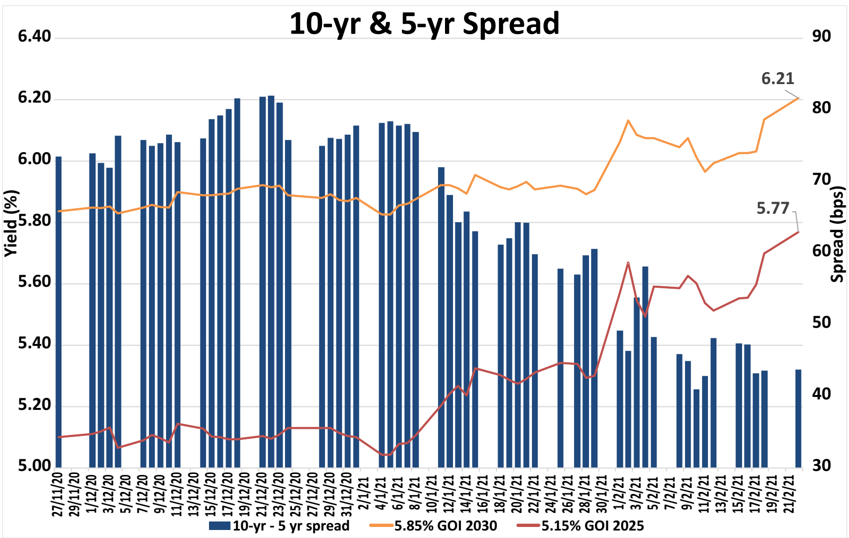
SPREAD MONITOR



SDL spreads are expected to continue facing upward pressure because of heavy supplies & general rise in G-sec yields



Heavy supplies slated for the upcoming year amidst better growth prospects, rising oil prices and sticky core inflation, keep demand for G-sec subdued



The spread between 5 yr and 10 yr paper plunges as demand for short dated papers wane amidst fears of normalisation of liquidity in the system

PNB Gilts Ltd

CIN: L74899DL1996PLC077120

5, Sansad Marg, New Delhi-110001
Ph. No: 011-23325759, 23325779

Company Website: www.pnbgilts.com

Research Mail ID: research@pnbgilts.com

For Fixed Income retail queries, kindly contact at:

Ph. No: 011-23321568, 23736586

Mail ID: marketing@pnbgilts.com