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The Economy Observer

Pre-Budget I: Will fiscal policy match monetary policy?

It must if bond yield is the new target

- **With the RBI's three back-to-back 'Operation Twist' transactions (OTTs), wherein it bought longer-dated securities amounting to INR300b and sold short-term treasuries worth INR253b, it is clear that the RBI (a) does not want to add meaningfully to its balance sheet, and (b) is targeting bond yields, wanting the yield curve to flatten.**
- **The OTTs, thus, are likely intended to offset the adverse impact of INR500-700b additional borrowings expected to be announced by the central government in 4QFY20 and keep the 10-year yield range-bound at ~6.6%, even after the supply hits the markets.**
- **However, recent developments – such as rise in crude oil prices, confirmed massive receipt shortfall and higher inflation – have brought back the benchmark 10-year bond yield to ~6.65%, only marginally lower than 6.70% before the first OTT was announced on 19th Dec'19 and as against 6.50% at the beginning of Jan'20.**
- **If the policy makers still want to target the bond yield and wish to keep it contained at ~6.6%, the fiscal policy has to match the monetary policy. This implies that the government must refrain from issuing additional dated securities to restrict the impact on the benchmark bond yield. Also, the higher fiscal deficit, if any, must be financed through short-dated bills and/or other non-market instruments such as NSSF, etc. With no further supply of dated securities, the 10-year bond yield is likely to remain range-bound and additional issuances of T-bills may flatten the curve more – in line with the monetary policy objective.**
- **Alternatively, the spending burden could be transferred to various CPSEs to mitigate the adverse economic impact. While issuances of sovereign bonds will remain unchanged, higher public sector borrowing requirement (PSBR) should keep the financial markets generally tight.**
- **India's fiscal (center + states) debt has increased from an almost 3-decade low of 66.6% in FY15 to ~70% of GDP in FY18 and is likely to cross 71% of GDP for the first time in a decade this year. Thus, targeting and capping the benchmark bond yield is of paramount importance because the gap between GDP growth and interest rate has turned negative for the first time in 17 years in FY20, making government finances unsustainable.**

What is the objective of RBI's Operation Twist?

Recent developments have brought back the 10-year bond yield to ~6.65%, only marginally lower than 6.70% before the first OTT was announced.

Beginning mid-Dec'19, the RBI conducted three weekly Operation Twist transactions (OTTs), under which it bought longer-dated securities (maturing in 2029) worth INR300b and sold short-term treasuries (maturing in 2020) amounting to INR253b. The fourth such OTT is scheduled for 23rd Jan'20. Thus, it is clear that the RBI (a) does not want to significantly expand its balance sheet by holding more sovereign bonds amid massive foreign capital inflows *(Exhibit 1)*, and (b) is targeting bond yields and wants the yield curve to flatten. Therefore, we believe that the OTTs are likely intended to offset the adverse impact of additional borrowings (of INR500-700b) expected to be announced by the central government in 4QFY20 and keep the 10-year yield range-bound at 6.6-6.7%, even after the supply hits the markets.

However, recent developments – such as rise in crude oil prices, likely shortfall in disinvestment, confirmed massive tax receipt shortfall and higher inflation – have brought back the benchmark 10-year bond yield to ~6.65%, only marginally lower than 6.70% before the first OTT was announced on 19th Dec'19 and as against 6.50% at the beginning of Jan'20 *(Exhibit 2)*.

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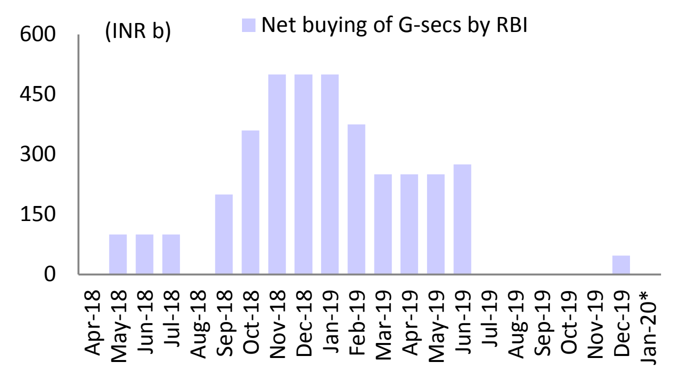
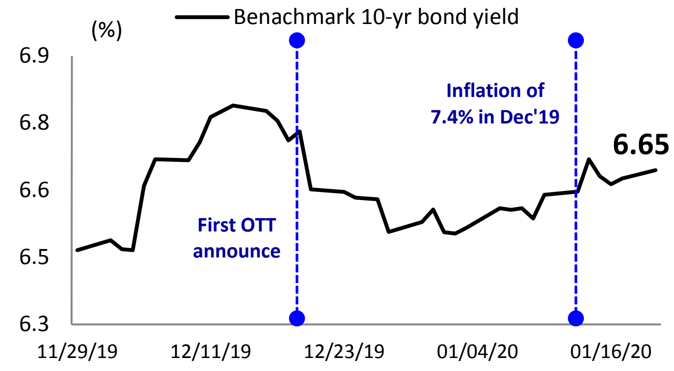
Exhibit 1: RBI has not expanded its balance sheet…



* Up to 20th Jan'20

Exhibit 2: …and 10-yr bond yield has risen back to ~6.7%



Source: RBI, Bloomberg, MoFSL

If the policy makers still want to target the bond yield at ~6.6%, the fiscal policy has to match the monetary policy. Also, the government must refrain from issuing additional dated securities.

If the policy makers still want to target the bond yield and wish to keep it contained at ~6.6%, the fiscal policy has to match the monetary policy. This implies that the government must refrain from issuing additional dated securities to restrict the impact on the benchmark bond yield. Otherwise, higher fiscal deficit, if any, must be financed through short-dated bills and/or other non-market instruments, such as NSSF, etc. With no further supply of dated securities, the 10-year bond yield is likely to remain range-bound and additional issuances of T-bills may flatten the curve more – in line with the monetary policy objective.

What is the economic impact?

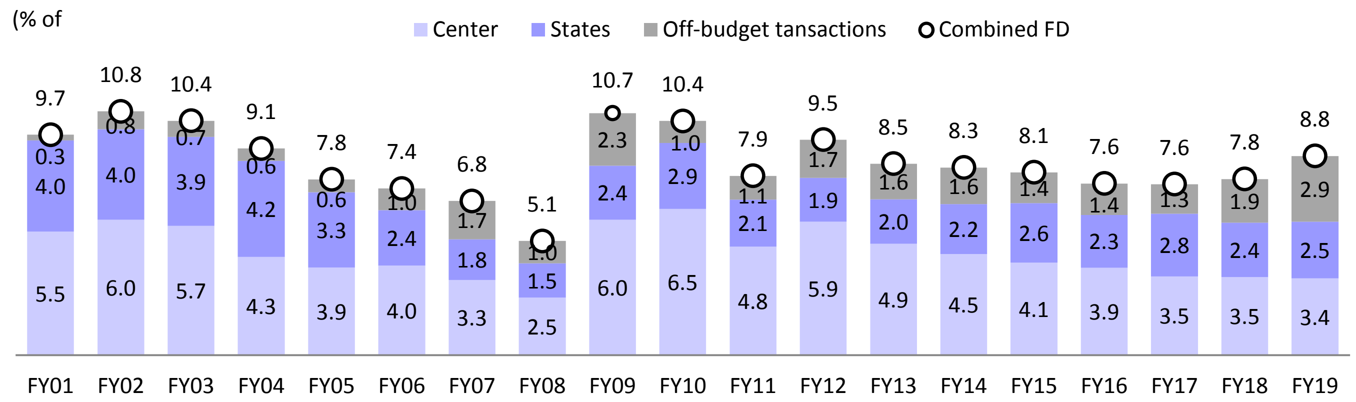
One of the major side-effects, as majorly argued, of sticking with the fiscal deficit, and thus, the market borrowing target is the adverse economic impact of the massive cuts in fiscal spending. However, what matters from the economy's perspective is neither the center's deficit nor states' or CPSEs in isolation, but a comprehensive assessment of all such fiscal borrowings called the 'public sector borrowing requirement (PSBR).'

What matters from the economy's perspective is neither center's deficit nor states' or CPSEs in isolation – but a comprehensive assessment of PSBR.

Although the fiscal spending cuts will be proportional to the massive receipt shortfall amounting to INR2.5t this year, the spending burden of the central government could be transferred to various central public sector enterprises (CPSEs) to mitigate the adverse economic impact – as explained **here** and just like in the past few years. Notwithstanding the spending cuts by the center worth INR1.3t and another INR4t by states in FY19, spending/borrowings of the CPSEs ensured negligible adverse economic impact but at the same time crowded-out the private sector.

Since the central government's reliance on extra-budgetary resources (EBR) has increased massively, reported fiscal deficit (RFD) needs to be carefully topped up with (net) borrowings of various government agencies to arrive at the center's true adjusted fiscal deficit (adj. FD). Our **calculations** suggest that the CG's adj. FD increased from a 9-year low of 4.8% in FY17 to 5.4% in FY18 and further to a 6-year high of 6.3% of GDP in FY19. Including the states' fiscal deficit, the public sector borrowing requirement (PSBR) was at least 8.8% of GDP in FY19, up from 7.6% two years ago in FY17 *(Exhibit 3)*.

Exhibit 3: PSBR was *at least* 8.8% of GDP in FY19



States' fiscal deficit excludes UDAY impact in FY16/FY17

Source: RBI, Budget documents, Company reports, MOFSL

While fiscal spending cuts by the center and states are inevitable (probably to the tune of INR5t or more) in FY20 as well, CPSEs and thus, PSBR would determine the economic impact. If CPSEs borrow more and push PSBR higher (like in FY19), then despite the center and states' spending cuts, there would be no fiscal contraction.

Why is it important to target bond yield?

India's fiscal (center + states) debt has risen from almost 3-decade low of 66.6% in FY15 to ~70% of GDP in FY18 and will likely cross 71% of GDP in FY20.

According to the revised FRBM architecture, the aim is to attain central government debt to GDP ratio of 40% (v/s 48% in FY19RE) and general government debt to GDP ratio of 60% (v/s ~70% in FY19RE) by 2024-25. During the past few years, however, India's fiscal (center + states) debt has risen from almost 3-decade low of 66.6% in FY15 to ~70% of GDP in FY18 and is likely to cross 71% of GDP for the first time in a decade this year *(Exhibit 4)*.

Exhibit 4: India's general government debt has risen in the past few years...

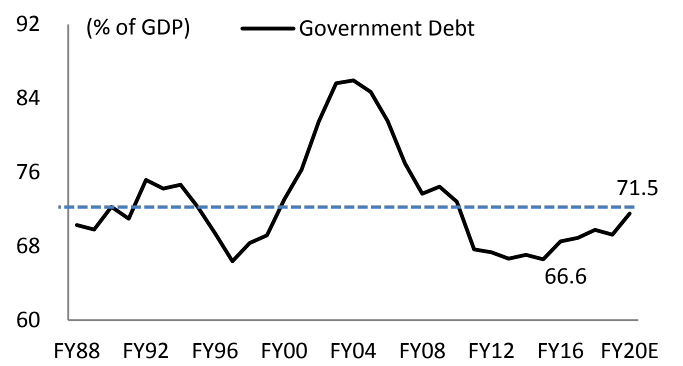
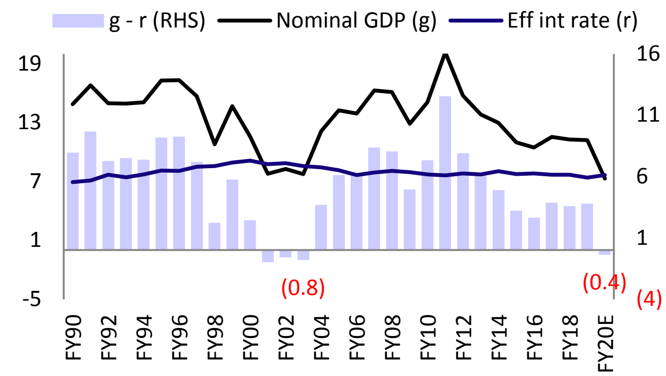


Exhibit 5: ...and interest rate was higher than GDP growth for the first time in 17 years



Source: RBI, Bloomberg, MoFSL

The gap between GDP growth and interest rate turned negative for the first time in 17 years, making government finances unsustainable.

What's worse, during FY15-19, fiscal debt increased despite the positive difference between GDP growth and the effective interest rate. With nominal GDP growth expected at 7.3% and effective interest rate at ~7.7% in FY20, the gap between growth and interest rate (g - r) will likely turn negative for the first time in 17 years, making government finances unsustainable *(Exhibit 5)*. Thus, targeting and capping the benchmark bond yield is of paramount importance.

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