

FIXED INCOME -TIMES



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Awaiting RBI : A Bond Update

The central government has revised its borrowing program by INR 4.2 lakh crores to INR 12 lakh crores for the full financial year. At approximately 2% of GDP, this is at the lower end of the expected requirements for additional financing by the government and by no means sufficient to bridge both the revenue gap as well as the discretionary stimulus ahead. This is true even after accounting for the substantial fuel excise tax hike announced recently. That said, nothing stops a further addition to the gross borrowing down the line. Alternatively, or additionally, other sources of financing including a heavier dependence on short term borrowing via treasury bills may be in play as well. Furthermore, the picture is yet to be clarified with respect to how states' financial distress is to be addressed.

The size of hike in borrowing notwithstanding, the template for the bond market is clear: this is the biggest growth shock to the global economy in multiple decades and the size of fiscal financing embedded in such a scenario can only be financed by the central bank. Indeed, in some form or fashion, this is the format across the world. Thus central banks are choosing to 'target' sovereign yield separately, focusing on expanding reserve money and general liquidity independently, or privately placing part of the government debt. The end result is largely the same for now. As observed recently by former RBI Governor Rajan, banks' reserves with the central bank ultimately go up. This is anyway the case today and there are very little inflationary consequences of this in the current environment. There may be additional reluctance for direct placement of bonds with the central bank, including possibly obfuscating market signals. However, the need for intervention is well established and the RBI can pick the means to do it. Indeed, monetization seems to have begun already with the RBI seemingly purchasing large sizes of treasury bills at the weekly auction.

Expectations from Monetary Policy

Developments over the past few weeks have caused most analysts to further downgrade their growth forecasts. Thus the lockdowns have extended with key economic centers in India classified as 'red zones'. Furthermore, the path of emergence from the lockdown seems relatively complex as any unequivocal comfort from the pace of progression in the virus has thus far been unfortunately elusive. Hence, the continued and enhanced role of pro-growth policies is well documented. **We expect further cuts in the effective overnight rate given that, irrespective of near term inflation due to supply chains being choked, the nature of this shock is overwhelmingly deflationary. However there is incrementally diminishing marginal utility of such cuts. Instead, RBI has to now play a larger role in the financing aspect of the economy. The obvious role is in financing the sovereign's deficit expansion via direct and / or indirect**

ways, as discussed above. It is to be noted that given the dynamics on expected evolution of credit to deposit ratio, the commercial appetite of the banking system for sovereign bonds itself would have been substantial in ordinary circumstances. However, as we have argued before, there is currently a marked lack of availability of risk capital in the system which is reflected in both the appetite for duration (interest rate risk) as well as credit. It is unlikely that this improves going forward, especially as the banking system is expected to see substantial accretion to stress in the time ahead on account of the unprecedented nominal growth shock that is currently underway.

Bond Market Implications

Given that the template is so obvious and almost globally accepted at the current juncture, we expect the RBI to reveal its hand soon enough to support the financing of the deficit. It may very well take the form of an indirect intervention for now, for instance through extension of the last twist operation undertaken (where the central bank was buying duration bonds and selling treasury and cash management bills to the market). There is also little sense in delaying such operations. With the number of uncertainties and moving pieces in the system currently, it makes sense to at least provide more certainty in the market for sovereign financing. Avoidable volatility (such as being experienced by the bond market at the time of writing) leads to unnecessary destruction of risk capital in the system. To that extent speed is also important in policy response.

We have flagged before the two drivers for long duration: One, valuation is very attractive when compared both on basis of term spread as well as versus expected nominal growth for the year ahead. Two, the dynamic between the known expansion in deficit and the somewhat unknown quantum of financing of this by the central bank is important. We have seen the first reveal here of the expansion in deficit but market yields are reacting to the absence of any absorption plan so far from the central bank of this excess duration supply. The base case here remains that such a plan is coming sooner rather than later.

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