SBI RESEARCH
ECOWRAP

A DUMB BELL STRATEGY FOR GOVERNMENT BORROWINGS COULD BE THE IDEAL ABRACADABRA FOR THE MARKETS!

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The recent geopolitical conflict has brought the focus back on government finances that might be derailed as the conflict intensifies. Against the possible impact on Government finances, the markets are already apprehensive of a larger borrowings. The Government has been quick to clarify that it is unlikely to borrow in March. Beyond this, the RBI does have a host of unconventional measures to manage Government borrowings in FY23 and it is important that debt market understands such nuanced undertows and does not get into a frenzy as it is swirling currently with crude prices threatening to move beyond $120.

The roadmap for proposed borrowing would require leveraging all plausible alternatives within the framework through a **'dumb bell' strategy**.

Firstly, such a strategy could explore higher share of T-Bills in the borrowing spreadsheet across all three time durations. RBI can mop up considerable additional amount under T-Bills route in all weekly auctions without disturbing the equilibrium, with a band of Rs 1500-2500 crore higher accretion set per week, as per market appetite and liquidity conditions in sight.

Secondly, Government may look to give a push to Small Saving Schemes. In particular, it can give a hard push to SSY (Sukanya Samriddhi Yojana), through encouraging fresh registrations in a mission drive mode, allowing one time registrations for all left over cases up to 12 years. Roping in Business Correspondent (BC) channel partners by banks can be extremely useful since banks have a low share vis-à-vis Post offices (~16% in number of SSY accounts though ~30% share in deposits).

Thirdly, the RBI can issue papers by matching the profile of redemption of Government paper. Ideally, papers up to 7 years in the short term segment, 10-15 years in the mid segment and beyond 15 years in the long term segment could be the ideal mix of meeting the borrowing appetite of market players. For short term segment, Banks, Mutual Funds (debt & hybrid), General Insurance Companies and Life Insurance Companies (ULIP & Hybrid) are the potential players. EPFO, Pension Fund, Other Provident Fund and Life Insurance Companies owing to their long liability profile are the players in the long term segment. A demand for the mid segment has to be created to keep the pressure off the 10-year segment by doing OMO in the mid-segment. From the redemption profile of the Government till FY43, we estimate that FY29, FY30, FY37 & FY38 have more legroom to absorb redemption.

Fourthly, a quarterly borrowing calendar, in place of half yearly calendar on the lines of T-bill and SDL calendar will provide Government the flexibility to manage borrowing in line with evolving revenues and expenditures.

Fifthly, FRB outstanding constitutes 5.5% of total G-Sec outstanding. Despite large outstanding, market liquidity in this segment is muted. To improve market liquidity and trading activity in this segment, RBI can earmark a portion of its OMO/OT programmes for FRBs.

Sixthly, instead of front-loading the government borrowings, RBI may, in consultation with GoI, spread its borrowing programme in 4 quarters and thereby keep the initial two quarters light or at least limited to 50% of budgeted programme.

Seventhly, auctions may be conducted twice a week instead of a single weekly auction at present.

Eighthly, switch auctions may be used proactively during first two quarters. This will help market participants to take into account lower maturities during next financial year (FY24) and increase demand for securities during FY23.

Meanwhile, the prolonged conflict brings into forefront the familiar Triffin Paradox and subsequent Ben Bernanke argument of global savings glut. A jump in Brent prices while pushing down US yields is pushing up domestic yields. Because the US dollar is the reserve currency, the US even after running the highest current account deficit actually supplies large amount dollars to fulfil the world's demand, which in turn leads to increase in indebtedness of the US, but that is not reflected in a commensurate increase in US yields. With no backing of gold after the breakdown of Bretton Woods system, the US just prints dollars when it wants to expand liquidity (and go for QE), but ultimately when it withdraws liquidity the greatest impact is on Emerging Market Economies.

We end with a positive abracadabra. Russia's bond offering that is aimed at foreign portfolio investors, called OFZ bonds had investments at around US$ 40 bn from participating overseas entities. **The turmoil post Ukraine invasion, along with sanctions imposed and country's rating downgrade can see investors readjusting their exposure, reallocating a greater percentage of assets earmarked for overseas destinations to India. Separately,** the holding in G-sec by LIC now have been around 19% while they were in excess of 20% during the years 2019, 2020. In contrast, the banking system ownership is around 38% while other insurers together own close to 5% of G-sec. **The listing of LIC should augur well for the bond markets as the insurance behemoth may have to deploy more chunk of inflows to safer avenues domestically.**

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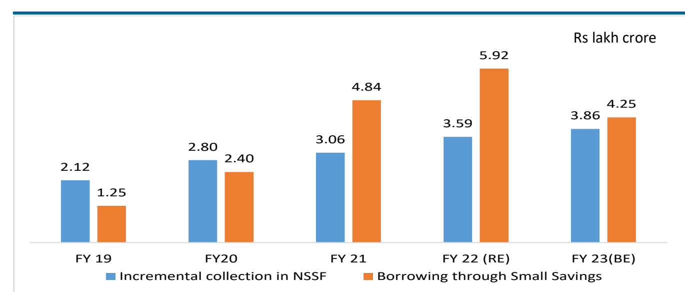
GOI BORROWING ROADMAP: USHERING INTO A DYNAMIC DEFICIT FINANCING MODEL

- The recent geopolitical conflict has brought the focus back on government finances that might be derailed as the conflict intensifies. The incipient volatility slithering across asset classes has now become broad-based across all economies and in particular emerging markets. Inflationary concerns are on the rise with firmed up commodity/energy prices further throwing into ensuing chinooks even the best laid plans of the policy makers across geographies. Interestingly, traders love volatility, markets long for stability; both abhor counter-intuitive surprises equally though. Policy makers would now need to establish zero trust deficit lines with broader markets on this count by aligning with roadmap that has little room for unexpected bends and curves. In this context, the role of RBI and Government becomes important.
- Against the possible impact on Government finances, the markets are already apprehensive of a larger borrowings. The Government has been quick to clarify that it is unlikely to borrow in March. Beyond this, the RBI does have a host of non-conventional measures to manage Government borrowings and it is important that the debt market understands such and does not get into a frenzy. **Against the wide spread notion of RBI behind the curve in raising rates, we believe a cross-section of the market was much behind the curve in fully grasping the divergence of the regulator from its global peers, with preferential treatment meted to growth remaining sacrosanct in mint street's hallowed books, at least for now.** Inflation though remains a concern and it might now become more of a pressing issue.
- Coming back to borrowings, for FY23, the Government has announced gross market borrowing through dated securities at Rs 14.3 lakh crore and taking repayments of Rs 3.1 lakh crore (adjusted for Rs 64,000 crore switch announced later) net market borrowing stands at Rs 11.2 lakh crore (67% of fiscal deficit).
- The higher than previously estimated market borrowings has kept the ecosystem at the edge, swiftly aided by hardening yield curve as rising geo-political tensions and unebbing energy and commodity prices press the panic button across multiple levers. Yields declined in between as there was a clear clarification from the Government of not borrowing to such a large extent, but jumped thereafter with the conflict.

A DUM BELL STRATEGY FOR BORROWINGS

- The roadmap for proposed borrowing would require leveraging all plausible alternatives within the framework through a **'dumb bell' strategy**".
- To begin with, such a strategy could first explore higher share of T-Bills in the borrowing spreadsheet across all three time durations and simultaneously enhancing the share of small saving schemes (Budgeted at Rs 4.25 lakh crore for FY23) in the kitty through a mixed model. Net short term borrowing has been pegged at Rs 50,000 crore currently.
- RBI can mop up considerable additional amount under T-Bills route in all weekly auctions without disturbing the equilibrium, with a band of Rs 1500-2500 crore higher accretion set per week, as per market appetite and liquidity conditions in sight.
- Separately, at present, the small saving schemes in operation include Post Office deposit schemes viz SB/RD/TDs, National Savings Certificate, Kisan Vikas Patra, Public Provident Fund, Deposit Schemes for Retiring Government Employees and employees of PSUs (SCSS).
- Interestingly, net collection under NSSF has been less than total borrowing through small savings in FY21 and FY22 (as per RE). In FY23 as well borrowing through small securities is higher than net collection during the year. Including recent offerings like SSY would put the corpus under administration at Rs 28.32 lakh crore which has grown at a CAGR of 16% in the last three years.
- Government may look at giving a hard push to SSY (Sukanya Samriddhi Yojana), through encouraging fresh registrations in a mission drive mode, allowing one time registrations for all left over cases **up to 12 years** since the scheme, having a far reaching beneficial safety net for girl child from all strata in their adult lives, has witnessed registration of 2.82 crore girl child only in the seven years since its inception in 2015, with ~Rs1.25 lakh crore savings accrued as on 31.01.2022, leaving enough leg room for further mop-up. Small Savings scheme seriously require a hard look now, with Post Office's complete onboarding to CBS likely to usher in greater two-way fungibility for investors in managing funds movement between Banks/Post offices and NBFCs going forward.

Net collection under NSSF and borrowing through small savings



Source: SBI Research

- Roping in Business Correspondent (BC) channel partners by banks can be extremely useful since banks have a low share vis-à-vis Post offices (~16% in number of SSY accounts though ~30% share in deposits. The newly opened accounts may be given enhanced saving limit in the first year to catch up with the lost-years for these new additions initially. Senior citizens, one of the classes at the forefront of battling pandemic's spill overs in the form of enhanced medical care allocation as well as stubborn inflationary trend eating into their investment returns, can be offered new saving instruments at rates matching those of SSY. With benchmark yields already reflecting incipient levitating cost of borrowing, the additional outgo on interest may not be significant while the accrual to the government, on both tangible as well as intangible fronts can be decisively crucial in managing borrowings.
- Applying Goldilocks rule, the market needs to brace for departure from all pervasive easy liquidity, in non disruptive fashion, through calibrated and inter-connected moves between all the stakeholders. While the government would be bracing for footing higher interest outgo on account of enhanced borrowing to assuage multiple socio-economic needs as also to check the waterfall effects of the Crimean war, the RBI has already sided with longer terms VRRR compensating banks' penchant for returns in days of abundant liquidity that remains marred by marginal avenues of profitable deployment sans risk.

ISSUANCE PATTERN

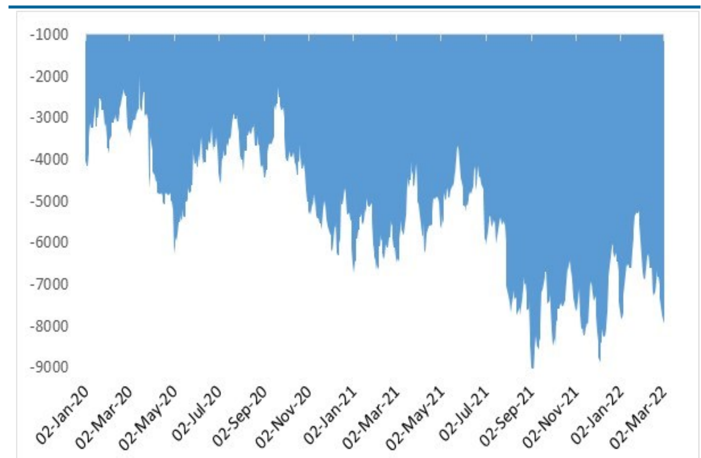
- Based on the ownership pattern of Government of India dated securities as on Sep'21 and given the total net borrowings of Centre at Rs 11.2 lakh crore, we believe demand of securities from banks to be around Rs 4.2 lakh crore (considering NDTL increase of 10% and 27% of SLR). The insurance sector could subscribe to Rs 3.0 lakh crore. Further, RBI may have to even ensure demand/OMO purchase of Rs 2.0 lakh crore. The rest amount will be purchased by PD's, Mutual Funds, FPI and others.
- Ideally, papers upto 7 years in the short term segment, 10-15 years in the mid segment and beyond 15 years in the long term segment could be the ideal mix of meeting the borrowing appetite of market players. A demand for the mid segment has to be created to keep the pressure off the 10-year segment by doing OMO in these segment.

T Bills Auction (Rs Lakh Crore)

Year	Particulars	Issues	Redemption	Net Borrowing
FY19	91-Days	6.6	7.1	-0.5
	182-Days	2.6	2.3	0.3
	364-Days	2.1	1.6	0.5
FY20	91-Days	6.4	6.5	-0.1
	182-Days	3.2	3.0	0.2
	364-Days	2.2	2.1	0.1
FY21	91-Days	7.4	7.3	0.2
	182-Days	4.9	5.1	-0.2
	364-Days	4.6	2.2	2.4
FY22(Till 25 Feb'22)	91-Days	7.8	7.0	0.8
	182-Days	3.8	3.7	0.1
	364-Days	3.3	4.2	-0.9

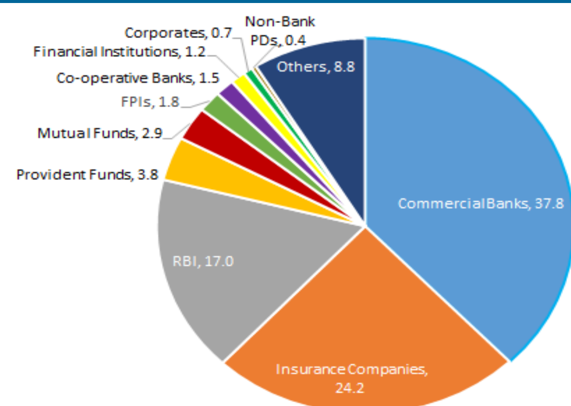
Source: CCIL, SBI Research

RBI System Liquidity-absorption (-), Rs billion



Source: SBI Research

Ownership Pattern of Government of India Dated Securities (% Share, Sep'21)



Source: SBI Research

- For short term segment, banks, mutual funds (debt & hybrid) General Insurance Companies and Life Insurance Companies (ULIP & Hybrid) are the potential players. EPFO, Pension Fund, other Provident Fund and Life Insurance Companies owing to their long liability profile are the players in the long term segment. In an upward rate scenario, banks are expected to prefer short term investments while insurance companies, provident funds etc. may step up their longer-term investments as rates move up.
- From the redemption profile of the Government till FY43, we estimate that FY29, FY30, FY37 & FY38 have more legroom to absorb redemption. Subsequently, papers of 6-7 and 14-15 years could be the options. This can be used as an essential input for structuring relatively seamless borrowing calendar.
- Bank's may have better investment appetite in their preferred tenors in H1FY23 as compared to H2FY23. H1FY23 borrowing, therefore, can be scheduled with higher proportion of securities in short and medium tenors while longer tenors may be more focussed in H2FY23.

GOVERNMENT FINANCES MAY BE READJUSTED

- The downward bias in benchmark US treasury yields as the war broke out, reflected the 'Stop and Pause' moment for broader markets to absorb the changed realisations that the Fed might not be following the dotted lines in keeping the pace of rising rates apart from the safe heaven hypothesis.
- The wide opposite divergence between spiking crude prices against benchmark US 10-Y yields declining of late reflects the risk-off sentiments. Against this background, the likely deferment of LIC's proposed IPO in the wake of upheavals in global markets can have limited repercussions through downward adjustments in capital expenditure from government during the current FY. This will leave enough elbow room to navigate the less than projected mop-up in disinvestment schedule.

TRIFFIN PARADOX

- The contrarian movement in US yields and crude is best explained by the Triffin Paradox. In 1950s during the period of Bretton Woods System, the US dollar became the primary international reserve asset. The gold-dollar system arose because growth in the global monetary gold stock was inadequate to finance the growth of world trade and output.

Proposed Issuance Pattern (FY 2022-23)

Tenure	% Share
2/3 years	10%
4/5 years	25%
10/15 years	30%
30/40 years	30%
FRBs (5/10)	5%

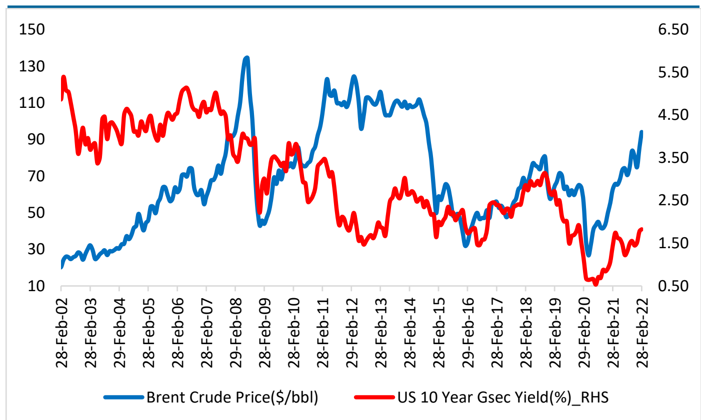
Source: SBI Research

Quantity and value of crude oil imports (India)

Year	Quantity (MMT)	Value ($ Million)	Value (Rs Lakh Crore)	USD/INR
2018-19	226	111915	7.83	69.92
2019-20	227	101376	7.17	70.73
2020-21	197	62248	4.60	73.86
2021-22 (till Jan'22)	176	94267	7.01	74.37

Source: PPAC, SBI Research

Brent Crude vs. US 10 yr G-sec Yield



Source: SBI Research

- The gap between global reserve demand and supply was filled by dollars produced by an accumulation of official short-term claims on the United States from the early 1950s. Against this backdrop, Robert Triffin postulated (later which was termed as the paradox) that if the United States eliminated its "overall balance of payments deficits" – its accumulation of short-term liabilities to the rest of the world – it would deprive the world economy of international liquidity needed for the expansion of global trade. Triffin argued that the subsequent gold shortage and the increasing use of the dollar as official reserves would inevitably lead to a run on US gold holdings.

- This would occur once outstanding dollar liabilities to the rest of the world exceeded the US monetary gold stock. This run would lead the US monetary authorities to tighten monetary policy, ushering in global deflation and, in the face of nominal rigidities, global depression.
- In other words, central banks needed to accumulate claims on the United States to back money growth. But the claims would eventually surpass the US gold stock and then central banks would inevitably stage a run on it. Triffin feared that the resulting high US interest rates would cause global deflation. As per the current account version of the Triffin paradox, owing to the reserve currency nature of the US dollar conflict can arise between the short term domestic and long term international objectives for other countries. Because the US dollar is the reserve currency, the US has to run a current account deficit so as to supply large amount dollars to fulfil the world's demand, which in turn leads to increase in indebtedness of the US. Thus, unsustainable growth of US external liabilities would plunge the world into deflation and depression.
- However, the critics are of the view that central banks do not depend on growing foreign exchange reserves to keep their money supplies growing. This was demonstrated by China in 2015-16 as its foreign exchange reserves fell from $4 trillion to $3 trillion, whereas M2 and credit growth continued to grow smartly at double-digit rates. The large debt of the US is not likely to lead to instability of the international monetary and financial system.
- Furthermore, prior to 1980, gross flows allowed dollar reserves to grow, without the US running current account deficit including through the financing of non-US current account deficits in the dollar. Also, renminbi reserves holdings reached one percent of global reserves by the end of 2014 (IMF (2015b), notwithstanding ongoing Chinese current account surpluses. Thus, it is not that the reserve currency nature of the dollar that is forcing the US to run current account deficit.
- Furthermore, with no backing of gold required after the collapse of Bretton Woods system, the US can print money and expand liquidity (go for QE) when required.

RBI's DOUBLE WHAMMY

- Interestingly, when the sudden reversal of capital happens, it is the emerging market economies, including India which suffer the consequences. Large capital outflows from India will put further depreciation pressures on the already sulking Rupee.
- However, rising oil prices puts the policy makers between Scylla and Charybdis. If the Government lowers the excise duty, then the fiscal deficit will rise which in turn implies higher market borrowing requirement, putting pressure on the yields following which RBI will have to hike interest rates. However, if it does not cut the excise duty on oil then prices of petrol and diesel will rise leading to higher inflation which would again call for rate hike by the RBI. Thus it faces a double whammy.
- Furthermore, as per the latest available fiscal data from CGA, capital expenditure has been only 73.4% of the BE so far till Jan'22. Meanwhile, if the current situation requires that LIC IPO is postponed then the RBI may have to reverse its sell-buy swap which it was doing to absorb liquidity in anticipation of higher liquidity brought in by the LIC IPO.
- **Thus it is imperative that Government borrowing program is smoothened through non-conventional actions**.

ADDITIONAL NON CONVENTIONAL MEASURES TO AUGMENT BORROWINGS

- **Quarterly G-Sec Borrowing Calendar:** A quarterly borrowing calendar, in place of Half yearly calendar on the lines of T-bill and SDL calendar will provide Government the flexibility to manage borrowing in line with evolving revenues and expenditures. It will also reduce the need to cancel scheduled auctions in case of surplus cash in government kitty. This will bring stability in market expectations and will reduce market volatility.
- **Floating Rate Bond:** FRB outstanding constitutes 5.5% of total G-Sec outstanding as on date. Despite large outstanding, market liquidity in this segment is muted and trading is often characterised by large volatility in prices, which goes against the nature of FRBs as a low duration product. To improve market liquidity and trading activity in this segment, RBI can earmark a portion of its OMO/OT programmes for FRBs. Also, RBI may plan to have FRBs with various maturities for development of proper floating rate yield curve.
- **Auction Schedule:** Historically, government has often front loaded its borrowing calendar to first half of the financial year. However, this year the market is expecting less borrowing than the budget estimates.

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- So, instead of front-loading the government borrowings, RBI may, in consultation with GoI, spread its borrowing programme in 4 quarters and thereby keep the initial two quarters light or at least limited to 50% of budgeted program. In case, government revenue continues to improve in line with growth estimates, it will anchor market expectations of borrowing being lower during H2 FY2022-23 and thus help contain the steep yield spike.
- **Twice a week Auctions:** Auctions may be conducted twice a week instead of a single weekly auction at present. This may be done by segregating shorter tenor and longer tenor auctions. It will help in better investment planning by market participants as well as in containing contagion effect spreading from one tenor to another.
- **Switch Auctions:** Switch auctions may be used proactively during first two quarters, instead of last two quarters to switch securities maturing in current / next financial year with longer dated securities. This will help market participants to take into account lower maturities during next financial year (FY2023-24) and increase demand for securities during FY2022-23. Further, to enable wider market participation, participants can be permitted to offer/bid securities separately in either leg. The current process of switching restricts participation only to the holders of source securities.
- **Introduction of On Tap Switch facility for G-Sec**: RBI may consider introducing an On-Tap Switch facility for switching of G-Secs. Under this facility, RBI may notify security pairs in advance for which switch transactions may be done based on previous day FBIL levels. This facility may be made weekly or bi-weekly based on response and feedback received from market participants. This will help in reducing the impact of bunched up supply hitting the market from switch auctions once every month.
- **Tweaks in HTM limit:** RBI has proposed reduction of HTM investment cap from 22% to 19.5% in a phased manner starting April 1st, 2023. In contrast, the discussion paper on Prudential Norms on Classification, Valuation and Operations of Investment Portfolio has proposed to remove the HTM upper cap for SLR securities and non-SLR securities are also permitted to be kept in HTM, proposed to be effective from 01st April 2023. These 2 contrasting views need to find the common ground.
- To get a proper transition path from present regulation to new prudential norms, and to facilitate smooth conduct of government borrowing program and orderly evolution of yield curve, the proposed reduction in HTM investment cap may be done away with. The implementation of removal of limits in HTM, proposed in the discussion paper for April 2023, may be advanced to start from April 2022 in a phased manner. Such an announcement will lead to better risk appetite for banks and will be cheered by bond markets.
- The discussion paper from regulator has proposed to discontinue inter category shifting of investment and 5% hard cap on sale of investment from HTM. A softer transitory approach for initial few years will help quell the fear of getting stuck on wrong side of interest rate movements and will act as a demand catalyst for G-Sec investment by banks.
- **Issuance Limits:** Presently issuance limit of a particular security has been informally kept at ~ Rs 1.4 lakh crores. As auction size has gone up substantially, within a quarter an active security is becoming illiquid. Hence, market player is attaching illiquidity premium while bidding in the auction. To avoid such additional pressure, wherever possible, individual security issuance limit (for bond of 10 year and more) can be increased to ensure the security liquidity for the entire fiscal.

BEYOND GOVERNMENT BORROWINGS

FUNDS FLOW TO INDIA CAN ACTUALLY IMPROVE: RUSSIAN OFZ BONDS AND EQUITIES LIKELY TO BENEFIT FROM ENHANCED INFLOWS TO INDIA WITHIN THE EM BRACKET

- Russia's bond offering aimed at foreign portfolio investors, called OFZ bonds had investments at around US$ 28 Bn from participating overseas entities, and additional US$20 Bn in Russian sovereign Eurobonds.
- The turmoil post Ukraine, along with sanctions imposed and country's rating downgrade can see investors readjusting their exposure, reallocating a greater percentage of assets earmarked for overseas destinations to India, the only country from the DM pack with lesser FPI investments in bonds (other than under Debt-VRR route) compared to peers with smaller population and economic scale. Equities too could see propitious shift from readjustments of MSCI and FTSE benchmarks.

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RUSSIAN ROULETTE

- Russia is the third-largest producer and second-largest exporter of crude oil. Other than Iran, it is the most significant pivot directing the upscaling energy prices today. Crude prices, hovering around US$112 at present have further leg room to spike to levels last seen in 2008 when wild swings were a norm on account of financial crisis.
- Government figures on inflation, borrowing and deficit financing are woven around lower spectrum of crude prices and upended prices can distort the worksheet, requiring recalibration of financing avenues. Also, the exclusion of Russian banks from SWIFT can have a cascading effect on world commodity and financial markets in unforeseen ways as settlement would be opaque though the sanctions on banks are by name and select banks not figuring in the list can evolve a back door alternative mechanism once the dust settles.

LIC: THE SYSTEMATICALLY IMPORTANT CONSTITUENT

- LIC holds Rs 23.5 trillion ($315 billion) worth of government securities, higher than even the central bank, and second only to aggregated Banking system out of the total central and state government securities worth Rs 115.2 trillion, according to the IPO bound behemoth's draft prospectus.
- The holding in G-sec by LIC now have been around 19% while they were in excess of 20% during the years 2019 and 2020.
- In contrast, the banking system ownership is around 40% while other insurers together own close to 5% of G-sec.
- The listing of LIC should augur well for the bond markets as the insurance behemoth may have to deploy more chunk of inflows to safer avenues domestically.

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