# Quickonomics

February 8, 2021

## Bond fatigue, dwindling options

The bond market is once again facing a gigantic borrowing programme by the central government to fund economic revival.

In pandemic-hit 2020, yields strayed from fundamentals and drooped to decadal lows despite a record rise in government borrowing. The counterintuitive happened because of extraordinary easing moves by both, the Reserve Bank of India (RBI) and global central banks.

This year will be different, though.

One, economic recovery is gaining momentum. That implies a pick-up in credit growth. Banks will now have more options than the government to lend to, which could put some pressure on G-sec yields[1].

Two, the RBI will have to keep an eye peeled for inflation amid an expansionary fisc and rising input costs, though in general, inflationary pressures are expected to remain under control.

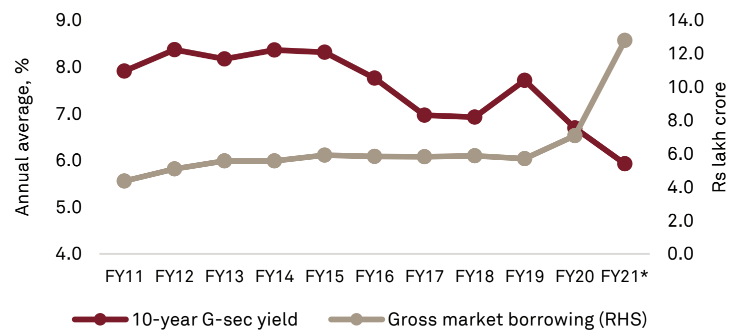
As of now, the RBI is not short on ammunition. But it may need to turn back the accommodative tap if inflation pressures rise. Some normalisation of liquidity has already begun.

Three, the RBI is also concerned about easy liquidity fuelling asset-price inflation and destabilising markets.

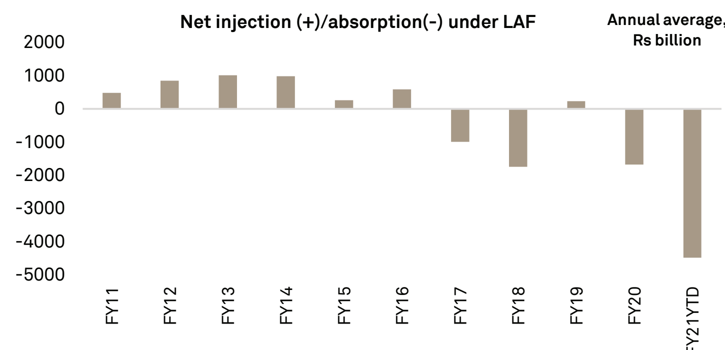
In other words, though the February 5 monetary policy review confirms the RBI's intent to support the government's borrowing programme next fiscal, maintaining such high levels of liquidity may no longer be easily possible.

We discuss the reasons for this here.

**Yields bore surge in government borrowing last fiscal...**




**...thanks to record surplus liquidity**




*Note: *FY21 number for borrowing is as per FY21RE; for yield, data is up to January 2021; LAF refers to liquidity adjustment facility; FY21YTD: April2020-January2021*
*Source: Budget documents, RBI, CRISIL*

### The bank credit growth effect

**High supply of government bonds...** The Centre has budgeted to borrow Rs 12.1 lakh crore next fiscal, only a shade less than the Rs 12.8 lakh crore in fiscal 2021(RE) and much higher than Rs 7.1 lakh crore in fiscal 2020. Stressed state finances means supply of state development loans could be copious as well.

**... and a pick-up in bank credit to private sector:** The sharp fall in economic activity, high uncertainty and risk aversion culled bank credit growth this fiscal. Consequently, banks put money into safe-haven G-secs much above the SLR[2] requirement of 18% of

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[1] *Yields are inversely related to bond prices and demand*
[2] *Statutory liquidity ratio*

NDTL[3]. Such investments rose from 25.7% in March to 28.6% in December 2020. But as the economy recovers, bank credit is expected to improve and so will the appetite of banks to lend to the private sector. That could affect demand for G-secs. CRISIL estimates bank credit growth to double to 8-10% next fiscal from ~4-5% this fiscal.

Simultaneously, an increase in spending leading to dis-savings by households could moderate deposit inflows at banks.

Meanwhile, rising crude prices could lend an upside to yields. CRISIL expects Brent crude to rise to $50-55 per barrel in calendar 2021, almost $10 per barrel higher than in 2020.

## The retail- and asset-price inflation effect

This fiscal, the RBI net absorbed ~Rs 4.4 lakh crore (monthly, on average) under the liquidity adjustment facility and supported the huge borrowing programme. But an encore is unlikely next fiscal because:

- **Inflation could play spoilsport:** While the Monetary Policy Committee (MPC) maintained its accommodative stance at the February policy meeting, it revised up its CPI[4] inflation projection for the first half of fiscal 2022 to 5-5.2% from 4.6-5.2% projected in December. Moreover, it voiced concerns on rising input prices (including crude oil) driving up core inflation. As demand recovers, these could be increasingly passed on to retail prices.
- **Asset price inflation could be destabilising:** According to the RBI's latest Financial Stability Report, "While easier financial conditions do support growth prospects in the short run, the longer-term impact in terms of encouraging leverage and inflating asset prices may give rise to financial stability concerns."

## How to read the RBI's latest signals

In ways, it has begun 'normalising' liquidity.

In January itself, the RBI resumed variable reverse repo rate operations, which now allows banks to park excess liquidity with it. During its Feb 5 review, the RBI also announced a two-step reversal of the 100 basis points (bps) cut in cash reserve ratio undertaken in March 2020. While this will gradually normalise systemic liquidity, it will also afford infusions through open market operations as and when required (read: to support the borrowing programme).

Further, instead of immediately announcing liquidity-boosting measures to support G-secs, the RBI has shifted focus to improving demand by introducing direct retail investor participation, and extending the enhanced held-to-maturity (HTM) limits for bank holding of G-secs until 2023.

## That said, global developments could lend a helping hand

In 2020, extraordinary easing by the US Federal Reserve and other major central banks gave the RBI space to enhance liquidity as well. The fact that the Fed has increased its tolerance for inflation will allow continuation of its accommodative stance. Moreover, even with the additional fiscal stimulus proposed in the US, S&P Global does not expect the Fed to tighten policy soon.

However, there is low foreign investor appetite for Indian G-Secs.

## 10-year yields to settle at ~6.5% by March 2022

Overall, we believe, supply pressures will have a bearing on the 10-year G-sec yield once the RBI starts unwinding its ultra-accommodative monetary policy stance. We expect the yield to settle at ~6.2% by March 2021 and rise to 6.5% by March 2022, which would still lower than the decadal average of 7.7%.

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*[3]Net demand and time liabilities*
*[4]Consumer price index-based inflation*

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