



Union Budget 2011-12: Expectations of the Market Borrowing Programme & its impact on G-Sec yields

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The planning for the final year of the Eleventh Five Year plan (2007-12) has led to significant curiosity. With a pall of uncertainty enveloping the voters' trust on the Government of India, all eyes would remain glued on the upcoming Union Budget for FY 2011-12. Grappling with crucial issues such as controlling inflation, fiscal consolidation, infrastructure development, domestic financial sector liquidity management to support growth, line up of crucial elections, absence of windfall gains (3G BWA sale), stoking investments and compensating for the tarnished image (scams), the Government is faced with the convoluted task of balancing the Union Budget amidst being populist on the one hand and popular on the other. Increasingly coalescing expectations would mandate the Government to steer its way to fiscal consolidation and impart momentum to the long pending reforms. The Budget would continue to retain the emphasis on inclusive growth while trying to maintain fiscal prudence.

Far from being over, the fixed income market fears have once again mushroomed and the numbers budgeted for the fiscal deficit and the market borrowing programme are cautiously awaited. This report aims at throwing light over the current apprehensions - estimation of fiscal deficit vis-à-vis market borrowing and its effect on Government securities' yields. The Union Budget for the year 2010-11 exhibited a muted stance towards expenditure and projected improved revenue scenario. The upcoming Budget would remain challenging as the Government would have to adopt a conservative stance with regards to expenditure amidst elections and a steady revenue growth.

The Current mix

I. Revenues:

We expect that Budget 2011-12 would not initiate any major changes in the tax structure despite the lobbying from industry to bring in concessions to the corporate tax regime as also in individual tax rates as the government moves towards implementing the Direct Tax Code in April 2012. A trend hike in the tax revenues is projected, seeing the buoyancy in the corporate bottom lines. Tax revenues can be expected to grow at a healthy rate of 20% in line with a buoyant collection witnessed for the current year. The key indirect taxes may not be tweaked majorly ahead of the DTC. The excise duty on petroleum products may be revised lower. With a fair pace of growth observed in the industrial production, the customs and excise collections too may be projected to rise. A major blow to the non tax revenues would be the absence of windfall gains in the form of 3G and BWA auctions as seen in the current year (budgeted at Rs.35,000 Cr, actual Rs.1,06,000 Cr).

Positives: Healthy tax
revenues, disinvestment

- *Limited upside to
revenue expectations*



The disinvestment proceeds may be set parallel with what was penciled in for the current year (Rs.40,000 Cr) forming a major portion of the Non-Debt Capital Receipts. Overall, the revenue side of the Budget 2011-12 promises an outlook comparable to the current year.

II. Expenditure:

Expenditure to be kept in check

- Total expenditure estimation: Rs.12,44,000 Cr

With limited upside on the revenue front, the emphasis of Budget 2011-12 would remain on reining in expenditure. The task seems a challenge with the Government scheduled to conduct elections in several key states. The rise in inflation has people expecting greater money in hand, whilst fiscal prudence demands anything but a populist budget. The Plan Expenditure would be in line with the Gross Budgetary Support approved by the Center. It is estimated at Rs.4,36,518 Cr for FY 2011-12 marking a YoY growth of 17%. With high oil and food prices, the subsidies are accounted for on an upside as compared to the current year. The Government would probably later consider deregulation of diesel prices to manage the oil subsidy burden. The Fisc would be burdened with extraordinary inclusions such as implementation of the food security bill. Considering Non-Plan Expenditure, the defense services would be supported with a 5% hike as against a decline seen in the current year. Interest payments and repayments are bound to go up by 14%. Marking a trend based growth in the expenditure for various other heads, the total non-plan expenditure is estimated around Rs.8,07,500 Cr. The total expenditure for the year to come is projected in the range of around Rs.12,44,000 Cr.

III. Budget Financial Outline:

Fiscal deficit seen around Rs.4,20,000 Cr

- Higher than current fiscal

Head	Budget Estimates 2010-11 (Rs. Cr)	Our Estimates 2011-12 (Rs. Cr)	YoY change (%)
Revenue Receipts	6,82,212	7,80,913	14.5
Tax Revenue (Net)	5,34,094	6,40,913	20.0
Non-Tax Revenue	1,48,118	1,40,000	-5.5
Non-Debt Capital Receipts	45,129	45,000	-0.3
Total Receipts	7,27,341	8,25,913	13.6
Plan Expenditure	3,73,092	4,36,518	17
Non-Plan Expenditure	7,35,657	8,07,469	9.8
Total Expenditure	11,08,749	12,43,987	12.2
Fiscal Deficit	3,81,408	4,18,074	



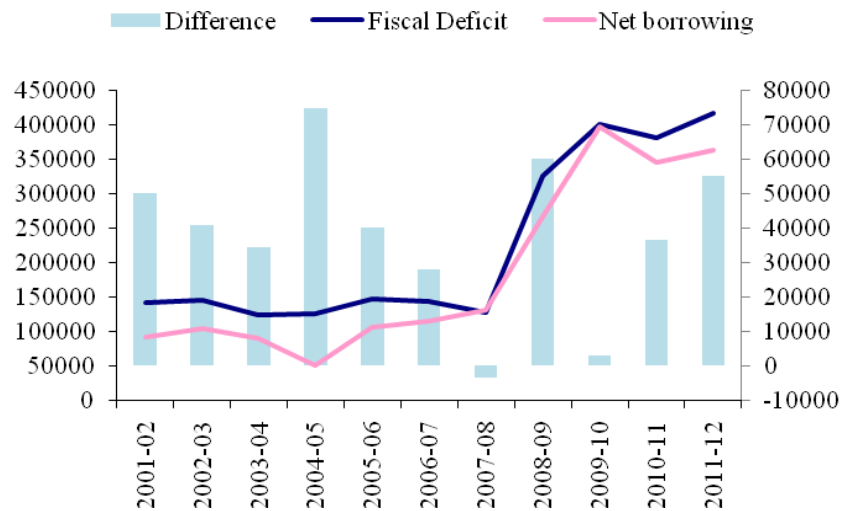
Considering the revenue and expenditure, our fiscal deficit estimation for FY 2011-12 stands at around Rs.4,20,000 Cr higher than the Rs.3,81,408 Cr for the current year. CSO's latest advance estimate for GDP growth at market prices for the year 2010-11 was marked at 20.3%. In expectations of a marginal slowdown in the GDP growth and a decline in the inflation for the next fiscal we expect the nominal GDP growth for FY 2012 to be pegged at 12.5% - 13%. Estimating a growth of 12.5% - 13% for the next fiscal the GDP at market prices would stand between Rs.88,00,000-89,00,000 Cr. Fiscal deficit at Rs.4,20,000 Cr would then imply a fiscal deficit to GDP ratio of 4.7%, close to the figure of 4.8% that has been targeted in the roadmap laid for the fiscal consolidation. Contrary to the same, if we approach the fiscal deficit from the GDP perspective, then 4.8% (as targeted) of the GDP for the next fiscal would come out to a fiscal deficit of around Rs.4,25,000 Cr.

IV. Government Borrowing:

Huge net borrowing

- Gross borrowing:
Rs.4.40 - 4.50 lakh Cr

The Budget deficit pegged at Rs.4,20,000 Cr can be financed via two options, viz. external finance and internal finance. Internal finance is further segregated into Market Borrowings, Other Borrowings and draw down of cash balances. Other borrowings comprise of small savings, state provident fund, special deposits, etc.



(Note: FD, Net borrowing – Left scale; Difference – right scale, in Rs)

Considering the historical data, apart from market borrowing we expect the deficit to be financed up to an extent of Rs.50,000 - 55,000 Cr via other options mentioned above. We expect a marginal reduction in the small savings collections in the coming year. The overall 'Other



Borrowing' estimates are pegged upwards. This leaves us with a Net Market Borrowing in the range of Rs.3,65,000 Cr to Rs.3,75,000 Cr. Redemptions for the year 2011-12 sum up to around Rs.74,000 Cr. Summing up the net market borrowing and the redemptions for the year, we estimate a Gross Market Borrowing in the range of Rs.4,40,000 - 4,50,000 Cr in comparison to Rs.4,47,000 Cr for the current year. With such a large borrowing and with limited tools to aid the same (viz. MSS buyback, MSS de-sequestering, OMO purchases, etc. as conducted earlier), the Central Bank faces the challenging task of ensuring a smooth completion of Government's borrowing alongside a tightening policy stance.

V. Managing the market borrowing programme:

Given the sheer size of expected market borrowing, the expected pick up in credit off-take and the gradual tightening of monetary policy, the borrowing is expected to be front-loaded. The start of the financial year could see a spike in the 10 year yield tracking the huge supply of primary issuances, the high inflation and possible rate tightening in the March Policy. The issuance of a new 10 year security would ease the pressure on the 10 year yield. The new 10 year security may mark a coupon of 8 – 8.25%. The 10 year yield could spike to as high as 8.40% depending upon the appetite seen in the primary auctions of Government Securities commencing in April 2011.

Tough task for RBI

*- 10 year yield seen
between 8.20 - 8.45%*

To ensure a non-disruptive borrowing, the RBI would try and space out the borrowing as evenly as possible. The yearend spending would ease liquidity pressures. RBI's stance of maintaining liquidity in a deficit mode to tame inflation may be altered in a manner conducive for the borrowing. Another option that could be tapped for greater G-Sec appetite is making FII investment in G-Secs more attractive (current limit is \$10 Bln) and not just confined to the longer tenor securities. With the rise in interest rates as monetary policy is tightened, incremental SLR demand would emanate tracking a rise in bank deposits. As compared to the current year growth in bank deposits (16%), the growth for the next year is expected to be in the range of 20-22%. The incremental SLR demand arising from a 20% increase in the deposits would be around Rs.2,50,000 – 2,60,000 Cr. The same may not completely translate into appetite for fresh issuances as the current systemic SLR is above the mandated 24%, however the proportion of this demand from the banking sector would remain the major support in the G-sec auctions next year. However, for the year ahead, a big relief could be the reversal of the SLR reduction announced in the current fiscal. Hike in the SLR rate from the current to 24% to 25% would roughly lead to G-Sec demand worth Rs.55,000 Cr.



Conclusion:

We expect a fiscal deficit in the range of around Rs.4,20,000 - Rs.4,30,000 Cr and a net borrowing figure in the range of Rs.3,65,000 Cr to Rs.3,75,000 Cr. The same would mean a Gross Market Borrowing in the range of Rs.4,40,000 - 4,50,000 Cr. The huge borrowing would definitely put upward pressure on G-sec yields and the 10 year yield is seen in the range of 8.20-8.45% in the first quarter of FY 2011-12. A lot would also depend upon the monetary stance adopted by the RBI. The pan out of macro variables would determine the rate tightening post the March mid-quarter review.



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