Fiscal Overrun might not mean a lot more borrowing

*Yesterday, the government decided to keep its borrowing program unchanged for the second half of the year from the budgeted figures. Given the balance of pressures and supports, we do not see a **significant borrowing pressure in H2** beyond what seems to be already priced in to the yield currently.*

We expect the fiscal deficit to rise to 3.6% of GDP in 2019-20 which amounts to an additional financing pressure of Rs. 54,000 crores. *In our previous note (Fiscal Stimulus for an ailing economy, 20 September 2019), we had mentioned that the isolated impact of the corporate tax cuts, in the absence of any expenditure cuts, was about 0.7% of GDP – implying a fiscal deficit of 4% of GDP. We have now accounted for a broader set of levers influencing the fiscal math and expect an overrun of 0.3% of GDP this fiscal. This is assuming that the government undertakes some expenditure rationalisation. Caveat: A significant upside to the fiscal numbers could come in if the government successfully executes its aggressive disinvestment plan. However, we remain cautious and have currently not factored in significant deviation from the budgeted disinvestment figure of Rs. 1.1 trillion for 2019-20.*

On the financing side, there could be some relief from additional borrowings from the National Small Savings Fund (NSSF). However, the budgeted figures already account for Rs. 1.3 trillion of financing from the NSSF. Besides, we are also factoring in a roll-over of food subsidies that in effect constitute increased borrowing by the Food Corporation of India (FCI) from the small savings fund. ***So while we do not expect additional market borrowings to equal the entire estimated fiscal slippage (of Rs. 54,000 crores), some additional borrowings seem likely (there isn't adequate recent data on the NSSF to make hard calculations).***

We had expected that the sovereign bond issuance could have been the big positive game changer for bonds this year. However, that now seems unlikely as the government said that all borrowings would be rupee denominated for now, this year.

We await the new 10-year paper before giving out our medium term forecast range for bond yields.

H2 Borrowing plan: No surprises

- As was widely expected, the government kept its H2 borrowing planned unchanged from the budgeted estimate. The government has planned to borrow Rs. 2.68 trillion in the second half of this fiscal which accounts for 37.7% of the total borrowing for the year. In the first half, the government has already borrowed Rs. 4.42 trillion – which is 62% of the total borrowing of Rs. 7.1 trillion for the fiscal.
- The government had planned Rs 500 billion of switches and buyback each this year. So far, Rs. 400 billion of switch operations have been done but no buybacks have yet been conducted. The Redemptions in H2 are higher at Rs. 1.4 trillion compared to Rs. 1.0 trillion in H1.

INR TRN	FY20	H1 FY20	H2 FY20
Gross G-Sec Borrowings	7.1	4.42	2.68
Redemptions	2.4	1.0	1.4
Buybacks	0.5	-	0.5
Net G-Sec Borrowings	4.2	3.4	0.8
% of Gross borrowings		62.27	37.75

Source: Finmin, Budget documents, RBI, HDFC Bank

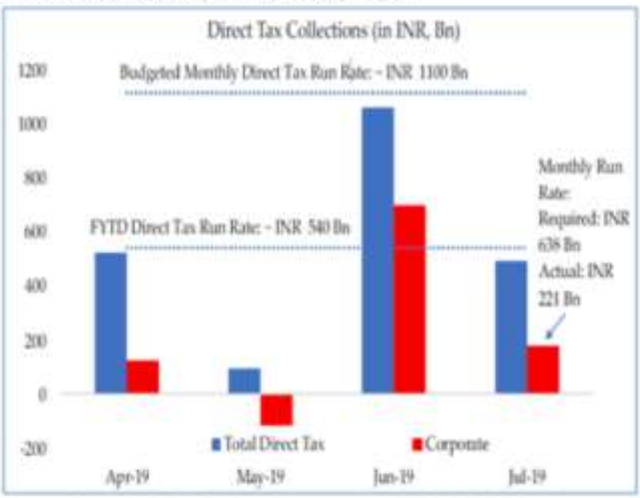
Balancing the fiscal math

The government has not accounted for any additional borrowings for now, in line with its fiscal deficit target of 3.3% of GDP. However, the number work shows that there are a number of pressures on the fiscal situation, apart from the recently announced corporate tax cut, that could raise the fiscal deficit figure this year.

Let's recap the fiscal trends so far. Until July, the fiscal deficit was tracking 77.8% of the budgeted estimate vs 86.5%, year ago. From the receipts side, both revenue and non-debt capital receipts have been largely similar to last year's collections. **<u>However, while the trend is similar to last year, it is disappointing when compared to the required monthly run-rate as per the budgeted numbers.</u>**

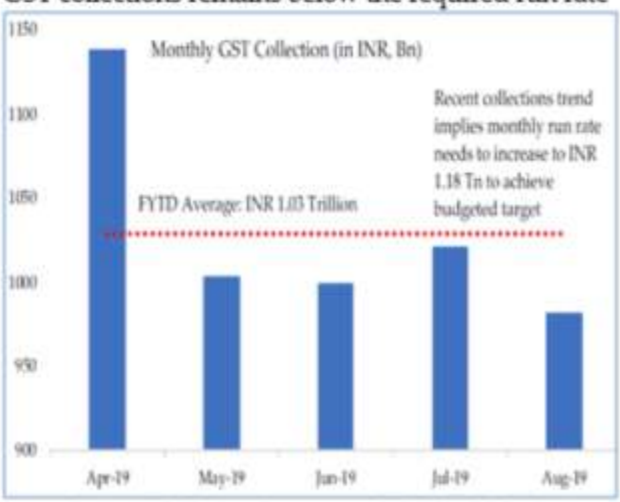
- For instance, **direct tax collections** have grown by a mere 6.5% so far as against a budget target of 18% for the fiscal year. In this, corporate tax collections have averaged at Rs. 22,100 crores between Apr-Jul 19 in comparison to a required monthly run-rate of Rs. 63,800 crores.
- For indirect taxes, the targeted growth rate for FY20 in GST collections is budgeted at 10% while so far this fiscal the growth has been close to 6.4%. After touching 1.13 lakh crore in April, GST collections have fallen off to INR 98,000 crore in August 2019.

Direct tax collections have been low



Source: CGA, Budget Documents, CEIC, HDFC Bank

GST collections remains below the required run rate



Source: PIB, Budget Documents, CEIC, HDFC Bank

The fiscal performance so far, and adding the shortfall on account of the corporate tax cuts, warrants a relook at the fiscal numbers. We estimate the fiscal deficit number in different scenarios.

Base Case: 3.6% of GDP in 2019-20

In our base case, we estimate the fiscal deficit could rise to 3.6% of GDP from the budgeted 3.3% of GDP for 2019-20. This amounts to an additional financing pressure of Rs. 54,000 crores in the fiscal.

- **Clarification over the corporate tax loss:** The government estimates that the total shortfall due to corporate tax reductions is close to Rs. 1.45 lakh crore. While many have argued that this number will actually be lower due to gain in tax exemptions and incentives forgone by corporates (in order to access the lower tax rate), we think the government is likely to have accounted for these adjustments before giving out the net revenue loss number.
    - That said, the Rs.1.45 lakh crore figure is likely to be the net loss to both the centre and the states. Therefore, the loss to the centre is likely to be close to Rs. 84,000 crore using the 14th finance commission devolution formula. The rule states that 42% of the collections accrue to the states and 58% are given to the centre.

- **GST shortfall:** We assume a GST and direct tax collection shortfall (close to Rs. 80,000 cr) and some additional expenditure burden due to recently announced scheme relating to exports and housing.

- **RBI transfers:** RBI surplus transfer (additional buffer of Rs. 58,000 crore) + RBI interim dividend for the current year (estimated same as last year at Rs. 28,000 crore).

- **Expenditure cuts:** While the government has said that they will not be looking at cutting expenditure for now, we think that there is a possibility that with expenditure roll-overs (like in the case of food subsidy), the government could buy some fiscal space. For instance, the government has on average rolled over 30% of its food subsidy bill to FCI over the last three fiscals. A similar roll-over this year could add close to 0.3% of GDP in fiscal space.

- On the disinvestments front, the government's aggressive disinvestment plan could amount to additional fiscal space. However, we remain cautious over the execution of the same (government has announced disinvestments in BPCL, BEML, Concor and SCI). Where the proceeds to be significantly higher than the budgeted figure of Rs. 1.1 trillion, there could be additional cushion to the fiscal math. At this stage, we have not build a significant increase in disinvestment receipts into our base case.

- **GDP assumptions:** We estimate nominal GDP growth of 10% y-o-y in 2019-20 compared to the budget estimate of 11%. A lower GDP number adds further pressure to the overall fiscal deficit target (as a % of GDP)

Pessimistic Case: 3.9% of GDP in 2019-20

The fiscal deficit could rise to 3.9% of GDP in this case with a borrowing overrun of Rs. 1.05 lakh crore.

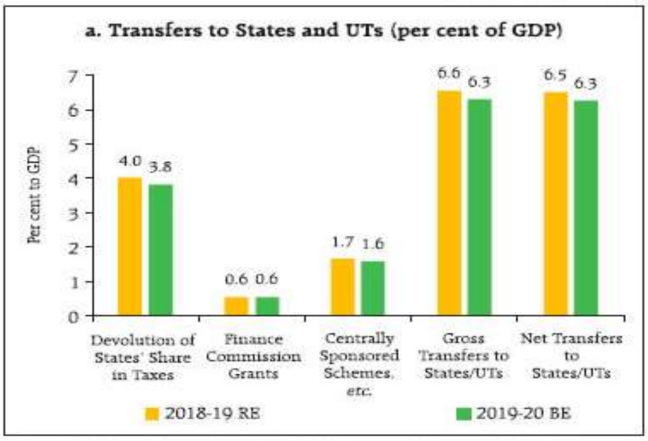
In this case, we assume a higher shortfall in GST and direct tax collections and a lower cut back in expenditure. In our pessimistic case, we are still assuming that some pickup in growth is likely to cap the shortfall in tax collections to Rs. 1.06 lakh crore this fiscal. To put things in perspective, last fiscal, the total shortfall in GST and direct collections was close to Rs. 1.8 lakh crore compared to the budget estimate.

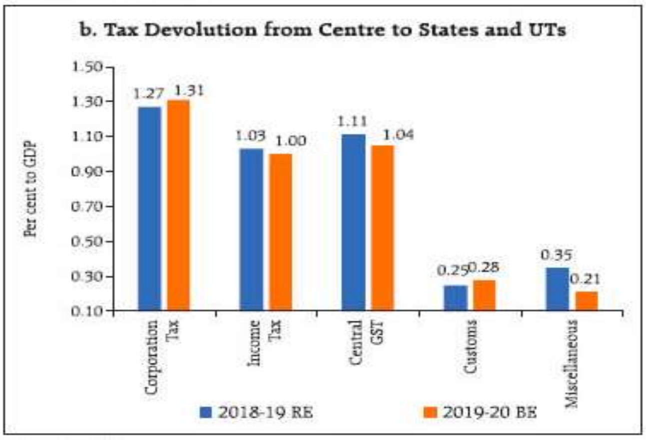
Fiscal Math Scenarios: Fiscal deficit expected to rise to 3.7% of GDP

Scenarios	Base Case		Pessimistic Case	
	INR bn	% GDP	INR bn	% GDP
Pressures				
GST & Direct Tax shortfall	-799	-0.4	-1,066	-0.5
Expenditure on other measures announced (exports, housing etc.)	-300	-0.3	-600	-0.3
Corporate tax shortfall (to centre)*	-841	-0.4	-841	-0.4
Cushions				
RBI surplus	580	0.3	580	0.3
RBI interim dividend expected	280	0.1	250	0.1
Expenditure rationalisation (subsidy roll-over etc.)	836	0.4	627	0.3
Net shortfall	-543	**-0.3**	-1,049	**-0.5**
New Fiscal Deficit	7,647	**3.6**	8,087	**3.9**
Budgeted Fiscal Deficit	7,038	3.3	7,038	-
GDP nominal	209112 (10% y-o-y)	-	209112 (10% y-o-y)	-

Source: Finmin, Budget documents, RBI, HDFC Bank

<u>States Fiscal Situation:</u> <u>Undoubtedly the centre has more cushions than the states to meet its fiscal obligations this year.</u> While states will also incur the cost of the corporate tax revenue shortfall (estimated at Rs. 60,000 crore) they do not have dividend transfers from the RBI to offset some of this decline. Moreover, this year, the transfers to states from the centre is also budgeted to be lower due to slower growth projected for the divisible pool of taxes. The combined state fiscal deficit is budgeted at 2.6% of GDP for 2019-20, but there is a high probability that this number could be higher.





Source: RBI, Finmin, Budget documents, RBI, HDFC Bank

Borrowing pressures

- **In our base case, the fiscal shortfall amounts to Rs. 54,300 crores this year. For now, the government has not announced any additional borrowing. But we could see some additional borrowing announcements in the last quarter once the government has a clear picture on its revenue shortfalls.**
- *On the financing side, there could be some relief from additional borrowings from the National Small Savings Fund (NSSF). However, the budgeted figures already account for Rs. 1.3 trillion of financing from the NSSF. Besides, we are also factoring in a roll-over of food subsidies that in effect constitute increased borrowing by the Food Corporation of India (FCI) from the small savings fund.* ***So while we do not expect additional market borrowings to equal the entire estimated fiscal slippage (of Rs. 54,000 crores), some additional borrowings seem likely (there isn't adequate recent data on the NSSF to make hard calculations).***
- To recall, last fiscal, too, the government drew as much as Rs 50,000 crore more from the NSSF, than budgeted, and cut gross market borrowing by Rs 34,539 crore from the over Rs 6.05 lakh crore projected earlier in order to reign in rising yields. In the last few years, the governments' reliance on the NSSF to finance its fiscal deficit has gone up from being just 1.8% in FY13 to 19.7% in FY19 and 18.5% of fiscal deficit in FY20 (Rs. 1.3 trillion this fiscal compared to Rs. 1.25 trillion last fiscal).
- The fact that the interest rate on small saving funds remains considerably higher than other deposit rates in the economy is also likely to attract higher deposits into the fund this fiscal. As of the July-September quarter, small saving deposit rates were between the range of 8.6% (for senior citizens) to 7.6%.

Fiscal Deficit Financing			
% of Fiscal deficit	2017-18 A	2018-19 P	2019-20 BE
Net Market Borrowings	76.3	66.6	67.2
Net Treasury bills	7.6	3.9	3.6
NSSF	17.4	19.7	18.5

Source: Finmin, Budget documents, RBI, HDFC Bank

Statement Showing Collection Under National Savings Schemes			
(Rs. In Crores)			
Year	**Gross(Deposit)**	**Withdrawal**	**Net**
2002-03	1,18,117.7	57,784.2	60,333.5
2003-04	1,48,920.9	78,069.5	70,851.3
2004-05	1,77,730.5	80,942.2	96,788.3
2005-06	2,00,148.0	1,15,061.6	85,086.4
2006-07	1,82,180.9	1,24,686.2	57,494.7
2007-08	1,47,708.8	1,48,731.4	-1,022.6
2008-09	1,58,510.0	1,67,961.2	-9,451.2
2009-10	2,50,931.3	1,86,622.2	64,309.2
2010-11	2,74,719.9	2,16,066.7	58,653.2
2011-12	2,21,913.2	2,18,819.3	3,094.0
2012-13	2,34,152.7	2,09,801.0	24,351.8
2013-14	2,50,421.0	2,06,617.2	43,803.9
2014-15	3,04,733.8	2,54,796.6	49,937.2
2015-16	4,45,973.8	3,39,035.5	1,06,938.3
2016-17	5,15,999.8	3,98,734.3	1,17,265.5
2017-18	5,92,710.4	4,35,596.5	1,57,113.9
2018-19 (Upto Nov-18)	4,01,060.3	2,99,548.9	1,01,511.4

Source: NSSF, Finmin, Budget documents, RBI, HDFC Bank

Bond View:

Pressures:

- Even as the government has not announced additional borrowings for now, fiscal worries are likely to keep the pressure on yields in the H2. We expect announcement of some additional borrowings in the Jan-March quarter. **Furthermore, concerns over the fiscal situation of states is likely to rise and keep markets jittery.**
- We had earlier expected that the announcement of a sovereign bond issuance could be the game changer for bond yields. However, in a statement yesterday, the Finance secretary mentioned that sovereign borrowings will be rupee denominated this year, reducing the possibility of foreign currency denominated borrowings this year.
- Risk: A significant shortfall in revenue collections in the case that growth fails to pick up could lead to a higher fiscal deficit figure and put pressure on yields.

Supports:

- RBI to cut rates further by 40bps this fiscal. We expect a 25bps cut in the October meeting. This could help reign in some of the pressure on yields.
- The issuance of the new 10-year paper could have some short term impact on the trading range. Expected to be 10-15bps lower than current 10-year yield levels.
- The government could announce a smaller additional borrowing in Q4, choosing to draw down on the NSSF to meet its fiscal deficit target.
- Continued FII EM debt flows as global yields turn negative, supporting bond prices domestically.

We await the new 10-year paper before giving out our medium term forecast range for bond yields.

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