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Debt Management Strategy

The Reserve Bank of India recently released the 'Medium Term Debt Management Strategy' for the first time, in line with sound international practices. Medium-Term Debt Management Strategy (MTDS) is a plan that the government intends to implement over the medium-term (three to five years) in order to achieve a composition of the government debt portfolio that captures the government's preferences with regard to the cost-risk tradeoff. MTDS has been initially prepared for a period of three years, i.e., FY16 to FY18. This document will be reviewed annually and the projections will be carried forward on a rolling basis for the ensuing three years. Currently, the scope of MTDS is limited only to central government debt. Over time, the scope would be progressively expanded to cover the entire stock of outstanding liabilities including external debt as well as State Development Loans (SDLs).

Evaluation of the current debt profile of the Central Government suggests that the debt structure of the country is well placed on various risk parameters such as rollover risk, market risk, creditor concentration risk and currency/ foreign exchange risk. However, efforts need to be focused on reducing concentration risk, which indicates higher redemption pressure of ~60% of total debt in the less than 10 years maturity bucket.

Salient Features of the Report:

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1. The baseline scenario of MTDS pegs the government's gross borrowing programme for FY17 at Rs 6.32 Lac Cr, based on certain assumptions. The scenario assumes that the government would stick to the explicit fiscal consolidation roadmap for the coming years, i.e fiscal deficit of 3.9% for FY16, 3.5% for FY17 and 3% for FY18. It also assumes nominal GDP growth for FY16-18 to be 11.5%, 12.2% and 12.4% respectively, as stated in the budget documents. Domestic inflation and exchange rate fluctuations too, are assumed to have negligible pressures.

2. The baseline borrowing suggests that redemption worth Rs 1.73 Lac Cr would be seen in FY17, with gilt switches to the extent of Rs 50,000 Cr being conducted in each of the following two fiscal years.

3. As far as the structure of issuances for FY17 is concerned, the document enunciates the following:

Borrowing Strategy (%age to total borrowing)			
Maturity Bucket	**2015-16**	**2016-17**	**2017-18**
< 5 yrs	0	0	0
5-9 yrs	16.5	16.0	15.5
10-14 yrs	44.5	44.0	43.5
15-19 yrs	19.0	19.5	20.0
20 yrs & above	20.0	20.5	21.0
Total	**100**	**100**	**100**

The above mentioned borrowing strategy would thereby lead to increase in average maturity of debt from 14.9 yrs in FY15 to 16 yrs in FY18.

4. Apart from projections for the forthcoming periods, the document indicates that gilt switches worth only Rs 30,000 Cr instead of the budgeted Rs 50,000 Cr may be conducted in the current fiscal. For the next two years, gilt switches are estimated at Rs 50,000 Cr each fiscal. The document also suggests issuance of a gilt switch calendar to better inform the market participants.

5. Once the baseline scenario is established, the document conducts stress test on the overall borrowing estimates. In view of this, the borrowing number is likely to fall in a broad range of Rs 6.60 Lac Cr – Rs 7.66 Lac Cr for FY17.

Key Takeaways of the report:

1. The MTDS articulates its estimations based on certain assumptions like the nominal GDP for FY16 being at 11.5% for FY16. However, the government has already reduced its nominal GDP projections to 8.2% in its Mid Year Economic Review.

2. The MTDS projections assume that fiscal deficit targets would be adhered to by the government as per the fiscal consolidation roadmap laid out. With the implementation of the 7th Pay Commission as well as One Rank One Pension, government finances are likely to come under severe pressure. The document remains silent on these particular aspects of fiscal strain.

3. The borrowing structure lays particular emphasis on increasing issuances on the longer end of the curve i.e. specifically in maturity buckets of 15-19 yrs and 20 yrs and above. In fact one of the key objectives of MTDS is to elongate the maturity profile of outstanding debt. In so far this fiscal, demand supply dynamics have been affected primarily because of two factors:

a. Sluggish growth of bank balance sheet. Deposit growth has significantly slowed from 13.6% in FY14 to 10.4% in so far this year.

b. Continuous rate cuts in SLR-HTM have severely curtailed demand for SLR securities. While SLR has been reduced from 23% in Apr-14 to 21.5% as at end of Dec-15, HTM too, has been reduced from 23% on Apr-14 to 21.5% by Dec-15. HTM would be further reduced by 50 bps starting 09-Jan-16 to 21%. Going forward, with SLR-HTM noting gradual reductions of 25 bps each per quarter, demand for G-Secs will further lessen.

4. The MTDS predicates that G-Sec demand from market participants would be in line with the trends seen in previous years. However, the actual case may not be so. As stated above, while reduction in SLR-HTM will continue to eat into G-Sec demand, change in investment pattern of long term investors, specifically the PFs too, has contained demand from that category.

   As per recent Labour Ministry guidelines, investments in G-Sec and SDLs have been clubbed together into one single category as against the earlier specific allocations of 25% for G-Secs. SDLs provide a better investment opportunity as they trade at a spread of 40-45 bps over G-Sec and hence, PF demand has been increasingly focused around the SDL segment. What would further dent demand for G-Sec are the expected large issuances of Special SDLs. As part of the UDAY scheme announced by the Government of India, states are expected to takeover 75% of outstanding debt of State Electricity Boards as part of the restructuring of discom debt. Such restructuring is likely to amount to Rs 3.23 Lac Cr over a period of two years, with ~Rs 2.15 Lac Cr being raised in Q4 FY16 alone, through issuances of special SDLs. Increased issuances of SDLs and Special SDLs will cause spreads to widen even more, causing significant demand-supply mismatch for G-Secs. Moreover, with FPI investments showing signs of slowdown in recent times, on account of recent INR depreciation and hardening of yields, demand from the category is likely to be unreliable and uncertain.

Overall, as far as government borrowings are concerned, it portrays an optimistic picture as important aspects like OROP and 7th Pay Commission do not seem to be accounted for. However, increased issuances in benchmark security may be a positive for the bond market, though only upto a certain threshold.

What may be of major concern is increased issuances of longer dated securities with no significant measures being undertaken to boost demand from long term investors. A small increase of 0.5% in each of two longer tenor maturity buckets translates roughly into an increased supply of Rs 18,800 Cr on the longer end of the curve. With

adverse demand dynamics at play for longer tenor securities, efforts at boosting demand for such securities to absorb the excess supply needs to be addressed to.

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