Front-loading: Centre allows states to borrow 75% of their annual limit in April-December

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Given the revenue constraints and an evolving Covid-19 situation, the Centre has allowed the state governments to borrow 75% of their annual market borrowing limit of 4% of their respective Gross State Domestic Product (GSDP) in the first nine months of the current fiscal, a senior finance ministry official told FE. This compares with the permission given to them to borrow up to 50% of the annual threshold in the year-ago period.

Coupled with the central government securities, the state development loans could boost supplies, leading to hardening of bond yields in the coming few months, unless the RBI steps up open market operations, analysts feel.

The idea behind the Centre's move is to enable states, which had bucked the trend in the last fiscal by reporting an year-on-year decline in capex, to regain spending momentum, even as they meet the rising spending commitments arising from the spike in Covid cases.

Conventionally, the states' borrowing used to be capped at 3% of GSDP or thereabouts, and the bulk of the borrowings occurred in the second half a fiscal year.

According to the source, the Centre has also mandated that states must spend 50 bps of the 4% unconditional market borrowing limit for the current fiscal year, on 'incremental capital expenditure' to improve the quality of spending.

Given the nominal GDP estimated in the Union Budget for FY22, the states' combined unconditional market borrowings could be around Rs 6.5 lakh crore in April-December of the year, thanks to the Centre's decision.

Constitutionally, states need prior approval of the Centre for undertaking market borrowings. The states, in coordination with the Reserve Bank of India (RBI), schedule the actual borrowings, subject to the threshold.

The FY22 borrowing by states is seen to be in the region of Rs 8.7 lakh crore, including about Rs 1 lakh crore earmarked for capex, due the mandatory stipulation of 50 bps capex.

Sixteen states reviewed by FE reported combined capital expenditure of Rs 2.16 lakh crore in April-February of FY21, compared with Rs 2.56 lakh crore in the year-ago period. This means that against their combined annual capex target of Rs 4.7 lakh crore for the year, these states achieved only a dismal 46% in the first 11 months of FY21. The capex by all states, a major pillar of public capex, must have seen a dip in FY21, even as the Centre and CPSEs managed to sustain the tempo, despite the pandemic.

"In accordance with the views of the 15th Finance Commission, we are allowing a normal ceiling of net borrowing for the states at 4% of GSDP for the year 2021-2022. A portion of this ceiling will be earmarked to be spent on incremental capital expenditure. Additional borrowing ceiling of 0.5% of GSDP will also be provided subject to conditions. States will be expected to reach a fiscal deficit of 3% of GSDP by 2023-24, as recommended by the 15th Finance Commission," finance minister Nirmala Sitharaman said in her Budget speech on February 1.

Last year, many fiscally weak states were forced to borrow from the market, at exorbitant rates.

According to the calender announced on March 31, the Centre will borrow Rs 7.24 lakh crore from the market in the first half of FY22, or just over 60% of the budgeted full-year target. The planned borrowing is higher than 56% in the first half of FY21, when a Covid-induced lockdown prompted the government to expand borrowing substantially in the second half as well.

Given the expected large supply of dated G-sec and state development loans in the coming months, as well as the likelihood of firming of global interest rates, yields are likely to rise in the absence of sizeable and frequent open market operations by the RBI.

Aditi Nayar, principal economist at Icra, had said yields were likely to rise in the absence of sizeable and frequent open market operations. "In our view, the benchmark 10-year G-sec yield may harden to as much as 6.35% by the end of Q1 FY2022," she said. "The 10-year G-sec yield is likely to be in 6.15%-6.30% range (from present level of 6.03%) in the next six to nine months and the spread on SDLs may widen a bit from the present level (6.8%)," said DK Pant of India Ratings.

While the first G-SAP (Government Securities Acquisition Programme) wasn't very successful, the RBI is likely to continue to use all instruments under its control including open market operations (OMO to keep the liquidity in surplus mode. "RBI will continue to sue these instruments frequently to manage yield; however, based on present situation and recent trends, it is unlikely that it will be very successful," Pant added.

On April 15, the Reserve Bank of India purchased Rs 25,000 crore worth of bonds under G-SAP, under which it has committed to buy Rs 1 lakh crore of G-secs between April and June to help absorption of the Centre's massive Rs 12.06 lakh crore borrowing plan for FY22. However, bond yields shot up more than 10 basis points after the first auction, casting doubts about its effectiveness in reining in yields.

In FY21, the central government raised Rs 13.7 lakh crore from the market, 93% more than previous fiscal's Rs 7.1 lakh crore, primarily on account of lower revenues and higher expenditure.

As their market borrowing limit was enhanced to 5% of GSDP (to about Rs 10.7 lakh crore) from 3% set initially last fiscal, state governments borrowed an aggregate of Rs 7.98 lakh crore, 26% more than the borrowings of Rs 6.3 lakh crore in FY20, according to Care Ratings. Tamil Nadu, Uttar Pradesh, Maharashtra, Karnataka, West Bengal, and Rajasthan have been the top seven borrowing states, accounting for 52% of the total borrowings in FY21, it said.

Speaking at the first of a series of online, agenda-setting debates organised by The Indian Express and Financial Times, Sitharaman said on last Thursday that front-loading of borrowings by the Centre and states in the current fiscal year would help harness the resources needed to keep momentum of public expenditure, including capex.

With the Covid-19 pandemic still prevalent, the existing interim ways and means advance (WMA) limit of Rs 51,560 crore (as against Rs 47,010 crore arrived at by a RBI committee)for all states/UTs shall continue for six months or up to September 30, 2021, the RBI said on Friday