No chance of a rate cut, RBI's challenge is restoring confidence in bond market

No one, including Indian government's chief economic adviser Arvind Subramanian, is expecting the Reserve Bank of India (RBI) to lower its policy rate this week when the monetary policy committee (MPC) meets.

RBI had last cut the policy rate in August, from 6.25% to 6%. Since then, the government paper yields have been spiraling, giving sleepless nights to bond dealers and most banks are staying away from the bond market for fear of making losses.

The yield on the 10-year benchmark paper has risen from 6.4% to 7.56% during this period. (If we take into the account the old 10-year paper, the yield has risen even higher, 7.76% on 2 February). At the shorter end, the yield on 364-day treasury bill has risen from 6.27% to 6.57% and that of 91-day treasury bill, from around 6.05% to 6.44%. Bond yields and prices move in opposite directions. The spread or the difference between India's policy rate and the government bond yield has widened substantially since August, indicating hardening of market rates even though the policy rate has not changed.

Clearly, the biggest challenge before the central bank is how to contain the rising bond yields.

This will probably be RBI governor Urjit Patel's toughest monetary policy. Will he change the monetary stance from neutral to hawkish? Will he raise the inflation projection? What will be his plan to contain rising bond yields?

Higher inflation target?

In its December policy review, RBI raised the projection of inflation in the second half of the current fiscal by 10 basis points—from a range of 4.2-4.6% to 4.3-4.7%. For fiscal 2019, I will not be surprised if it raises it further, say around 5%.

There are many reasons behind it—an expansionary budget and fiscal slippages in both the current fiscal year and next year (3.5% vs 3.2% and 3.3% vs 3%), rising crude prices and a budget proposal to ensure minimum support price of kharif crops 50% higher than of cost of production. The retail inflation quickened to 5.21% in December, a 17-month high and higher than most analysts' estimates, on rising food and fuel inflation.

Similarly, RBI is expected to raise the growth projection for the next fiscal year. In the December policy, it had kept the growth projection unchanged at 6.7% for fiscal year 2018, expecting 7% growth in the December quarter and 7.8% in March quarter after economic growth slumped to a three-year low 5.7% in the June quarter and bounced back to 6.3% in the July-September quarter. RBI will probably peg the growth estimate for 2018-19 at 7-7.5%. Most research houses are penciling a strong recovery beginning in the fourth quarter.

Future action data-driven?

By definition, when inflation rises and growth perks up, demands for a rate cut go out of the window. Still, just after the budget, RBI may not sound extra hawkish and retain its stance that its future action would be data-driven. It's another matter that it might not be easy for the central bank to hold on to the current policy rate in the second half of fiscal 2019. Many analysts are seeing policy rate at 6.5% by December 2018.

While future actions of RBI will indeed be data driven—among others, the progress of the

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monsoon, prices of crude oil, inflation trajectory and growth impulse in the economy—the immediate task is bringing back confidence in the bond market. More than the bond yield, volatility is a bigger worry. Unlike in the equity market, there is no volatility gauge for the bond market (a la VIX of National Stock Exchange) but take a look at the rise and fall of bond prices on a given day and you would know what I mean. For instance, on 2 February, a day after the budget, the 10-year paper yield fluctuated between 7.48% and 7.68%, some 20 basis points which translates into around Rs1.40, 10 times of normal market volatility. One basis point is a hundredth of a percentage point. This is happening in an extremely thin market where the volume of trading is less than even one-fourth of what we had seen last year. In such a market, there aren't too many buyers and RBI has been cancelling bond auctions or they are being devolved. On 22 December, a Rs3,000 crore floating rate bond auction devolved on the primary dealers who buy and sell such securities. A week later, on 29 December, RBI cancelled Rs11,000 crore of a Rs15,000 crore auction. On 5 January, a Rs4,000 crore long-bond auction (of 40 years and 16 years) was cancelled. On 19 January, yet another Rs4,000 crore auctions of 6 year and 28 year papers got cancelled. Finally, a day after the budget, Rs11,000 crore auction was cancelled—there was no takers. No bank wants to buy government paper for fear of making losses. With the sharp fall in yields, the treasury losses of public sector banks in January would probably be double of what they had lost in the entire December quarter. I will not be surprised if a substantial portion of the government's Rs88,000 crore fund infusion into 20 public sector bank gets wiped out by their treasury losses.

OMO sell?

To be sure, bond yields have been on the rise in most developed markets on economic recovery. The 10-year US yield rose to a four-year high of 2.85% last week.

Probably, the level of yields on Indian bonds in the first half of the current fiscal year was lower than what they should have been because of adequate liquidity in the system.

RBI soaked up the liquidity by selling Rs90,000 crore worth of bonds through its so-called open market operations, or OMOs. The market is blaming that for the current state of affairs and demanding that the central bank should step in to infuse liquidity by buying bonds from banks under OMOs.

That could be one way of managing the market but there is no systemic liquidity deficit as such and once the government starts spending (which it had not been doing since December), ample money will return to the system.

Indeed, certain banks are facing liquidity deficit because they are lending (all banks are not lending.) Besides, the rise in the bank's liquidity coverage ratio, or LCR, has also contributed to the liquidity issue, at least for some banks. Currently, Indian banks are required to buy government bonds to the extent of 19.5% of the so-called net demand and time liability (NDTL) a proxy for deposits as statutory liquidity ratio, or SLR, and, from January, they need to maintain 90% LCR to ensure that they have sufficient high-quality liquidity assets to survive any stress for 30 days. In the aftermath of the global financial crisis, the Basel Committee on Banking Supervision put in place this architecture to make the banking sector resilient. Of course, banks can use more almost 50% of their SLR holdings (9% vs 19.5%) for LCR. With the cost of money rising fast, State Bank of India has raised bulk deposit rates by 50-140 basis points and a few banks have raised loan rates. Some new private banks are paying more than 7.5% for one-year certificate of deposits in their rush to buy money for maintaining LCR. In the term money market, the cost of three-month is now 7.35% and that of six-month, 7.55% even though the overnight call money market has not shown any strain as yet.

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The limit on foreign investors for buying government bonds can be raised to create demand but it has its own challenges. Currently, the limit is Rs2.55 trillion for central government securities and Rs45,000 crore for state government bonds. Foreign institutional investors have used 97% of the limit for central government bonds. If the cap is raised, foreign funds will flow but that will lead to appreciation of the local currency which is not exactly wanted. So, RBI will have to step in—first, to buy dollars from the market and then to issue bonds for sucking out liquidity created out of the dollar buying.

Intervention in bond market

Indeed, bond sales under OMO will also increase liquidity and encourage banks' bond buying, but RBI needs to be more creative to restore the confidence of banks and bring them back to the bond market. One way of doing that could be intervention—buying bonds from the market something which RBI does in the foreign exchange market. It needs to do it aggressively to iron out volatility and not necessarily pushing down the yield. (It follows the same philosophy in the foreign exchange market—intervention for managing volatility and not defining the level of the rupee vis-à-vis dollar.)

It can also float more floating rate bonds and relatively shorter-term government papers to help banks hedge risks.

If RBI refuses to acknowledge that all is not okay in the bond market, managing government's Rs6.06 trillion gross market borrowing in 2019 will not be easy. The cost of borrowing for the government will rise, adding to its fiscal strain. And, banks will not wait for the next rate hike to raise loan rates.

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