The Indian economy's bond market challenge

The State Bank of India, India's largest lender by assets, surprised analysts last Friday by reporting a net loss of Rs2,416 crore for the third quarter of the current financial year. Apart from the issue of non-performing assets (NPAs), the big reason for slippage was higher provisioning on account of rising bond yields. Yields on the benchmark 10-year government bond have gone up by about 100 basis points since September 2017. The fall in bond prices will make things more difficult for public sector banks, as it will impede their plan to raise capital from the market and could further increase dependence on the government for capital infusion. This will also affect their ability to lend to the productive sectors of the economy at a time when investment is showing signs of revival.

Apart from banks, higher rates will have an effect on at least two additional levels. First, as the Indian economy is witnessing signs of revival, lower interest rates would have augmented the recovery. A recent study by India Ratings and Research showed that Rs1 trillion worth of debt among the top 500 borrowers could potentially fall into the stress category if the interest rate increases by up to 75 basis points until 2018-19 from the effective rate of 9%. Higher interest rates will increase debt servicing cost for firms, affecting profitability and their ability to make investments. This would also put further strain on the banking system.

Second, even though most of the government debt is at a fixed interest rate, a higher rate would mean higher interest outgo on fresh borrowing. The Reserve Bank of India (RBI) had to cancel bond issuance in the recent past due to higher yields. However, it will now have to accept the market price to complete the borrowing requirement. The central bank has rightly indicated that it will not manage yields. An increase in interest payment will directly affect expenditure on developmental activities.

However, in the given economic backdrop, it is likely that yields will remain elevated in the foreseeable future. The monetary policy committee of the RBI expects inflation to be in the range of 5.1% to 5.6% in the first half of the next financial year and moderate in the second half. Last week, in its bimonthly statement, the rate-setting committee highlighted at least six areas of uncertainty, which could affect the inflation outlook. It is possible that some of the risks will actually materialize and force the committee to raise the policy rate sometime in the next financial year.

There are a number of factors that will keep bond prices under pressure. For instance, while it is being argued that the impact of raising minimum support price (MSP) to 1.5 times the production cost would be minimal, it is not clear how the government will compensate farmers who are not able to sell their produce at the MSP, as announced in the Union budget. This could significantly increase expenditure. Further, rabi sowing has been low this year, which can affect production and prices. It has been reported that wheat output could fall to a three-year low, resulting in a significant increase in imports.

Although crude prices have moved both ways in recent months, it is a risk, especially in the context of strong global growth. Also, the rise in crude has not been fully passed on to the consumer. A higher retail price will push inflation or will affect government finances if oil companies take the hit. Both these possibilities will affect the bond market negatively.

On the revenue side, it is important that the goods and services tax (GST) stabilizes soon. Any indication of further fiscal slippage will push up bond yields. The bond market will also be influenced by international factors. Tightening financial conditions in the global market—primarily owing to the possibility of faster than expected rate hikes in the US in response to a tightening labour market and higher fiscal deficit—will put pressure on bond prices. Significant reduction or reversal of capital flows would also affect the value of the rupee. While a depreciating rupee will help exports, it will also push inflation.

Finally, the expected pickup in economic activity and demand for credit will also affect the cost of money in the economy.

Therefore, the combination of possibilities suggests that the increase in bond yields is unlikely to be reversed significantly in the foreseeable future. While the overall economic outlook is positive, relatively lower market interest rates would have further supported the recovery. That said, things could change if crude witnesses a sharp correction or the GST collections surprise significantly on the upside in coming months. Higher GST collection will reduce the need for borrowing, both at the central and state levels, and would help reduce the interest rate in the bond market.

Will higher bond yields affect economic recovery in India? Tell us at views@livemint.com

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