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COST OF BORROWING

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

After dropping below 6.3 per cent in the opening hours of trading on Wednesday, the 10-year government bond yield closed the day at 6.35, falling to levels last seen in the aftermath of demonetisation. Since the Union budget was presented on July 5, G-Sec yields have fallen by more than 30 bps.

This faster than expected decline in yields can be attributed to several factors. First, by sticking to the path of fiscal consolidation, despite doubts over its revenue projections, the government seems to have assuaged the concerns of the bond market.

Second, despite the associated risks, the proposal to meet part of the Centre's borrowings through international markets, which would reduce the supply of government paper in the domestic market, has had a salutary effect.

Third, with growth faltering, the case for greater monetary stimulus, especially with the monetary policy committee shifting its stance to accomodative, strengthens. A rate cut in August looks certain.

Fourth, there has been a significant easing of liquidity conditions in recent months. Fifth, globally, central banks are increasingly adopting a dovish tone, making Indian G-Secs an attractive investment. But, notwithstanding the decline in government bond yields, the fundamental question of transmission remains. Will the fall in G-Sec yields lead to a commensurate fall in the cost of funds across the broader economy? And will this help stimulate investment and consumption?

The trends over the past few months indicate that transmission of lower rates has been faster in the corporate bond market than in bank lending rates. Corporate bond yields fell by 34 bps between April and June according to CARE ratings. There is scope for further decline.

With the term premium falling, there is likely to be a gradual fall in credit risk in the coming quarters, as the risk perception of some segments, particularly that of NBFCs, reduces once the recent policy initiatives kick in. This would lower the spread between corporate bonds and G-Secs enticing corporates to raise more funds through the bond markets. Corporate bond issuances have in fact risen of late, averaging Rs 41,044 crore in May and June, up 67 per cent from April.

In the case of banks, the transmission of lower interest rates has been to a lesser extent, as banks' cost of funds continues to remain high. It is only when the cost of funds (deposits) comes down that banks will lower lending rates. To ensure greater transmission, in addition to greater clarity from the RBI on its liquidity management framework, the government would do well to closely align interest rates on small savings with G-Sec yields.

Though it has recently cut the interest rate for small savings by 10 bps, a closer alignment in the coming quarters could lead to a gradual fall in bank deposit rates, translating to lower lending rates to the broader economy.

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