India’s $22 billion bond market

The bond market also drives India’s economy which is otherwise slowing, inflation is sputtering and the central bank is cutting interest rates. But the cost of long-term money is refusing to budge. The reason, in a single word: upcoming elections. Polls are scheduled in states. Prime Minister Narendra Modi probably would have liked to make NDA’s reelection endorsement with less distress in the farm economy and a better jobs track record. If he hadn’t scored an own goal by banning 86 per cent of the country’s cash overnight, he might even have succeeded. Team Modi will end the fiscal year on March 31 with a huge deficit of roughly $190 billion, a pre-poll bump that doesn’t appear to have helped in pump-priming the economy.

The Gross Domestic Product (GDP) in India grew 0.70 per cent in the first quarter of 2020 over the previous quarter. It comes as little surprise that the country recorded its slowest GDP growth rate recently. More weakness is expected in the coming three months ending December 2020. That can only mean more disinflation and deeper interest-rate cuts. Why, then, is the 10-year Indian government bond yield doing very well, more than double the expected inflation rate for the year?

For both NBFC and corporate categories of bonds, the ranges grew by nearly 30-40 basis points between February 2020 and

April 2020. For both, the credit spreads attained their peak in the first half of May, close to 180 basis points for NBFCs and 170 basis points for the corporate bonds.

What’s troubling the market — beyond the known $100 billion deficit for the next fiscal year — is the additional, below-the-radar government funding it’s being asked to provide. India Ratings & Research Pvt., a unit of Fitch Ratings Inc., calls it “extra-budgetary resource,” a euphemism for public spending via borrowings that are, for all practical purposes, sovereign liabilities (though not counted as such).

Consider the top 10 public enterprises that borrow either to create economic infrastructure, such as the National Highways Authority of India or distribute state subsidies, such as the Food Corporation of India. While the liabilities sit on their balance sheets, their ability to repay comes from the government. A Food Corp. bond flopped after India introduced a clause diluting the agency’s sovereign backing, Cogencis reported.

It is the Indian households whose savings are being cornered by the government. For this to pay off, public spending has to make businesses and families more optimistic about investing and consuming. That could have happened a lot sooner were it not for the 2016 demonetization, or the spotty implementation of a badly designed goods and services tax. The bond market does provide an alternative.

But more worryingly, and to Team Modi’s disappointment, animal spirits aren’t reviving quickly enough — despite simultaneous fiscal and monetary stimulus, as well as regulatory easing and $39 billion in central bank liquidity infusions since May.

The bond market is holding this campaign hostage.

If the 10-year yield stays elevated despite slowing growth and inflation, high real long-term interest rates will further depress private borrowers’ sentiment. And this when nonbank lenders’ moods are already sullen. The sudden bankruptcy of an infrastructure financier last September has raised their funding costs; a housing glut is adding to the nervousness around builders’ debt. With credit-risk premiums unlikely to narrow any time soon, it’s all the more important that India’s risk-free rate should fall.

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