Dysfunction In Bond Market

(Mains GS3: Indian Economy and issues relating to planning, mobilization, of resources, growth, development and employment.)

Context:

- Government debt in India increases in the wake of COVID-19 which leads to more income inequality.
- Interest on government debt is a transfer from taxpayers to savers (who own government bonds).
- As the debt outstanding in India is primarily domestic, it is just a transfer from one hand to the other within the economy. Tax for one is income for the other.

Decision makers in government are less concerned:

- Unlike private borrowers, who are greatly concerned about their cost of borrowing, decision-makers in governments are not directly affected by the interest rates on offer, and therefore are less worried.
- However, the government's cost of borrowing does matter.
- The large increase in debt to GDP means interest costs as a share of GDP could be higher than earlier (for state and central governments put together), limiting its ability to spend elsewhere, specially on social sector development.
- This increase in interest rate also affects the cost of borrowing for large parts of the economy.

Concerns due to term premium and credit spread:

- The RBI sets the repo-rate, which is the short-term risk-free rate.
- That is, the loan must be repaid in a few days and there is almost no risk of default.
- The rate at which the government borrows is the long-term risk-free rate.
- It is risk-free as the government can, in the worst case, print money to service its repayments, but the lender wants higher returns given the longer duration of the loan.
- The difference between the repo rate and government's borrowing cost, say on a 10-year loan, is called the term premium.

- When a private firm takes a 10-year loan, it would have some credit risk too, which means a credit spread is added to the 10-year risk-free rate.
- Of the two, it is the term premium that poses the bigger challenge, currently, to policymakers.
- From an average rate of 73 basis points since 2011 (one basis point is one-hundredth of a per cent), and 120 basis points in 2018 and 2019, the 10-year term premium is currently 215 basis points, having risen 35 basis points since the budget presentation, and among the highest in the world.

Unpredictable Indian financial market:

- Financial markets are forward-looking, and as the collective expression of the views of thousands of participants where ones can occasionally "predict" what comes next.
- But the Indian bond market is not one such, the Indian bond market is still too illiquid and not diverse enough to predict future trends.
- Even though some pandemic-driven measures are being withdrawn, the MPC (Monetary Policy Committee) continues to be accommodative, headline inflation is unlikely to force an abrupt change.
- The spurt in yields after the budget points to the causality being fiscal instead of inflation-related.

fiscal rationale seems weak.

- Compared to what the bond market was anticipating, the union budget projected higher bond issuance of Rs 80,000 crore in FY2020-21 and Rs 60,000 crore in FY2021-22.
- Since then, the Centre's tax collection for FY2020-21 has been substantially ahead of target, and state governments have also borrowed Rs 60,000 crore less than expected.
- Further, 14 states (accounting for three-fourths of all state deficits) have budgeted FY2021-22 deficits at 3.3 per cent, far lower than the 4 per cent average expected earlier.
- Just these factors suggest that total bonds issued by the central and state governments should be lower than what the market had feared before February 1, when the union budget was presented.
- And yet, government borrowing costs have not returned to pre-budget levels.

Need to diversify government bond buyers:

- Over 15 years, the share of banks in the ownership of outstanding central government bonds has fallen from 53 per cent to 40 per cent now.
- This policy has correctly tried to reduce financial repression (that is, forcing banks to deploy the deposits they collect into government bonds).

- But no alternative buyer of size has emerged to fill the space vacated by banks despite improving penetration of insurance and formalisation driving growth in pension inflows.
- The RBI sometimes buys bonds to inject money into the economy, but of late this space has been used to buy dollars to save the rupee from appreciation.

Steps to be taken:

- As tinkering with the share of funds that banks, insurance or pension funds must deploy in government bonds may be inappropriate, the solution may lie in getting new types of buyers.
- The RBI opening up direct purchases by retail investors is a step in this direction, though it may not become meaningful for a few years.
- The share of government bonds that foreign portfolio investors (FPIs) can buy has been raised steadily, but without Indian bonds being included in global bond indices, these flows may not be meaningful, and would be volatile.
- To enable inclusion in bond indices, the RBI and the government have earmarked special-category bonds which are fully accessible (FAR) by foreign investors.

Conclusion:

- The FTSE (Financial Times Stock Exchange) putting India on a watch-list for "potential future inclusion" in the Emerging Markets Government Bonds Index.
- as "global index users have shown interest in Indian government securities issued through the (FAR)" is a step forward,this might trigger similar actions by other index providers.
- This is good not just for the government's own fiscal space, but also to ensure that the cost of borrowing in the economy is conducive to a post-pandemic recovery.