

Bond yields cool off before Reserve Bank of India's monetary policy

RBI watchers call for a CRR hike to support OMOs

Last Updated at February 10, 2022 01:25 IST

The bond market has eased its pressure on the Reserve Bank of India, opting to wait patiently and evaluate every word of Governor Shaktikanta Das when he spells out the policy on Thursday. It will also weigh any statement on how the central bank looks to manage the government's record borrowing programme while continuing with a normalisation exercise.

The bond market had panicked seeing the Rs 14.95 trillion gross market borrowing number in the Budget on February 1, notwithstanding a switch done on the eve with the RBI, which would reduce it by at least Rs 63,000 crore.

The 10-year bond yield hit 6.93 per cent following the Budget and the RBI refused to sell bonds in its auction at the market ask. On Monday, the central bank doubled down on that by cancelling an auction scheduled for Friday, citing a comfortable cash balance position of the Centre.

The RBI actions have cooled off the yields rapidly. The 10-year bond yields closed at 6.82 per cent on Wednesday.

“The cancellation of the auctions, and the fact that until March, there are only two auctions, give the 10-year bond a good carry until next month. There was a lot of short covering in the last few days also,” said Rahul Singh, senior fund manager, fixed income, at LIC Mutual Fund.

The expectations of a softer inflation number in the US, due on Thursday, also has calmed nerves globally, reflecting a dip in emerging markets bonds. A section of the market is also expecting some moderation in the borrowing numbers. The market saw the government doing that for this fiscal year at least.

“For the current fiscal year, if one includes both back-to-back GST compensation-related borrowing that the government decided to subsume into its borrowing and recent cancellations of bond auctions, the number is expected to be substantially lower than what was initially announced. It is possible that eventually there is some reduction for the next fiscal year, as well,” said Suyash Choudhary, head of fixed income at IDFC Mutual Fund. But any reduction would likely be modest and be revealed only later in the year, he added.

The market has also read an implied assurance from the central bank that there would be ample support to manage the huge borrowing, even as the central bank gets busy packing its extraordinary monetary measures offered during the pandemic years.

Exactly how the accommodation can be done is not clear yet, considering the central bank has stopped infusing extra liquidity through a guaranteed bond purchase programme since October. But analysts are now talking about open market operations (OMO) that can be done to purchase bonds from the secondary markets. The formal arrangement of a government securities acquisition programme (G-SAP) may also come back on the table.

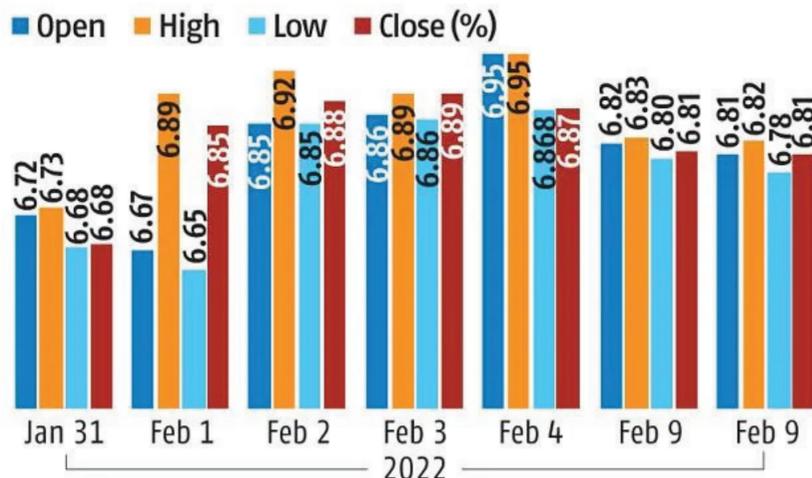
The extra liquidity can be removed by hiking the cash reserve ratio (CRR), they say. This will not only enable the central bank to carry on with its liquidity neutralisation operations, but it can also cool off the bond yields.

Thursday's policy and subsequent discussions will only make it clearer but hinge on how it is communicated to the market by the RBI governor, experts say.

“A huge bond supply in FY23 (even with upside surprise on tax revenues) will require the RBI's invisible hand more visibly, implying return of pre-committed G-SAPs. An uncomfortable RBI may neutralise that with CRR hikes, albeit it will face some communication challenges,” wrote Emkay economists Madhavi Arora and Hitesh Suvarna in a report.

According to Badrish Kulhalli, head of fixed income at HDFC Standard: “There is sufficient demand for the supply of bonds for the rest of the quarter. Moreover, the markets expect the RBI to reiterate its support for an orderly evolution of the yield curve, and also mention that it can use OMO / Operation Twist to help push through the borrowing smoothly.”

10-YR GSEC YIELD: UP & DOWN



Source: Bloomberg; Compiled by BS Research Bureau

But both Kulhalli and Joydeep Sen, advisor, fixed income at Phillip Capital, do not fully subscribe to the CRR hike angle. “It will burden the banks with a greater amount of non-earning assets,” Kulhalli said.

Sen said that expectations of OMO purchase also looks difficult, “given the surfeit of liquidity.”

Therefore, this policy will be closely watched by the bond market as it would likely turn out to be “radically different” than the previous ones, as Ananth Narayan, senior India analyst, Observatory Group, put out in his note.

Nonetheless, analysts and the Street are pricing in, at most, a 25-basis point (bps) hike in reverse repo rate, along with holding the accommodative stance. **Those at Brickwork Ratings expect the central bank to hike policy rates in its April 2022 policy meeting, as growth remains fragile and bond yields are trading higher.**

The 10-year bond yield has risen since the December policy meeting, while tightness in liquidity has led to some short-term market rates rising above the repo rate. However, the pace of the adjustment in market pricing may not be liked by the RBI.

Given this, Rahul Bajoria, chief India economist, Barclays, said if these events are left to continue it will only be a matter of time before trends in market rates get transmitted into retail lending and deposit rates. "In our view, maintaining control over broader financial conditions in the economy requires the RBI to remain an active presence in markets," he added.

Barclays expects the central bank to keep the repo rate on hold but to narrow the policy rate corridor by undertaking a 20-25 bp hike in the reverse repo rate partly.