

Demonetisation impact: Flush with funds, banks may cut lending rates

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Anup Roy | Mumbai November 16, 2016 Last Updated at 09:51 IST



The jury may be still out on the effects of

demonetisation but a consensus is developing that it will bring down the interest rate.

Yields on 10-year government bond, a benchmark of the prevalent rate in the economy, have fallen more than 25 basis points since Prime Minister Narendra Modi scrapped Rs 1,000 and Rs 500 notes on November 8.

Banks opened the next day amid chaos, as people rushed to the branches to exchange their old notes and to withdraw up to the limit of Rs 4,000. The rest of the old notes will go directly to the banks as low-interest-earning current and savings account deposits. The high-value notes made up Rs 14.1 lakh crore of the cash in circulation. If a substantial portion of that comes back to the banks, there will be a massive spike in deposit base.

This will bring down the cost of funds for banks. The lenders are trying to figure out where to put the cash. Therefore, the deposits are being invested in bonds, leading to a spike in the prices of the papers.

Bond yields and bank lending rates have a direct relationship. After the new methodology of lending rate calculation came in, any incremental drop in cost of funds, including through the fixed income route, has to be passed onto the customers.

Fitch said in a statement: “This durable increase in the deposit base will create more demand for government bonds and other high-rated bonds in an environment of tepid credit demand. Additionally, benign retail inflation trajectory will keep aid investors’ appetite for bonds.” As bond prices rise, yields fall.

Yields on the 10-year bonds had closed at 6.798% on November 8, before the prime minister announced demonetisation. The yields closed at 6.53% on Tuesday (November 15), falling 26 basis points. Since the start of the month, yields have fallen 28.5 basis points. One basis point is 0.01 percentage point.

Interestingly, India seems to be the only major economy that is bucking a global bearish bond trend.

Since the start of the month, yields on German bunds have risen 12.50 basis points, on US 10-year bonds have risen 38.44 bps, on Turkey’s bills have gone up 82.50 bps. Yields on other emerging market bonds have shot up by at least 30 basis points.

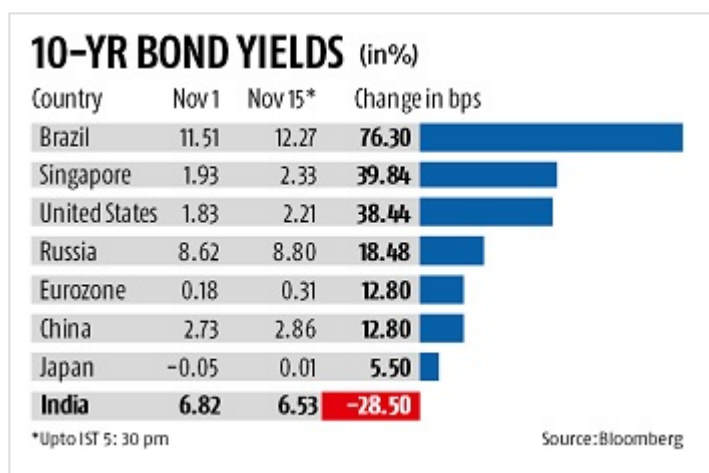
The liquidity flush might force the Reserve Bank of India (RBI) to sell bonds in the secondary market, so that liquidity can be absorbed. This is the opposite of what the central bank has been doing so far. To infuse durable liquidity into the banking system, RBI had bought Rs 2 lakh crore of bonds from the secondary market in the past one year.

“The initial increase in banking system liquidity is likely to be so substantial that RBI will have to resort to measures to mop-up of liquidity beyond its usual tool chest of daily- and term-reverse repos (both fixed and variable). In fact, we do not rule out open market operation sales, possibly in short-term bonds,” said a Nomura report.

On daily basis, banks have parked more than Rs 80,000 crore with the RBI in the past few days through various liquidity operations windows.

The liquidity conditions will also force the banks to lower rates.

State Bank of India Chairman Arundhati Bhattacharya told Business Standard in an interview on Monday that her bank’s margins would come under pressure due to the demonitisation exercise. Chairman of the New Development Bank of BRICS countries, and former managing director and chief executive of ICICI Bank, K V Kamath said in a television interview the rate cuts by banks could be as much as a full percentage point.



But will the lending rate cut translate into higher quantum of lending? Unlikely, said rating agency ICRA Ltd.

“Higher bank deposit mobilisation is unlikely to have a commensurate impact on lending in the near term, despite our expectation of some transmission to lower lending rates,” said Karthik Srinivasan, co-head, financial sector ratings, at ICRA.

The money might continue to be invested in bonds and the yields would continue to fall, taking interest rates of banks with them.