Debt Capital Markets at the Forefront of the $5 trillion Economy

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Blink. Circa March 2020. In order that India's economy laps the mark of $5 trillion by 2024 from the current levels of $2.7 trillion, our nominal average nominal GDP has to appreciate by about 12% and the real GDP at a pace of about 8% (assume 4% inflation and USD/INR maintaining status quo) over the next 5 years. A herculean task by all measures!!

In the past, we have had the luxury of doubling our GDP only once in the 2003-08 period. The period was replete with global economic growth as well as overseas trade and investments. The domestic indicators were robust with high savings rates, bank credit growth of about 20%. Further, the export growth in that period driven by thriving global trade also helped in maintaining USD/INR exchange rates at similar level. Indian economy, though resilient, has weakened by a mile.

Fast Forward. Four months and "one" COVID later, the impediments to our goal have exponentially multiplied and conventional tools of math and logic seem to suggest that the road to a $5 trillion economy is bumpier and has been pushed beyond 2024 (how many years beyond, anybody's guess, & hope I am wrong). Till this precarious situation subsides, it is premature to comment upon the economy numerically but one should always craft the drivers that will get us closer to the goal post.

With the mission of a "self-reliant" India comes an exorbitant amount of spending (and not only guarantees) which has to be fulfilled by debt funding. A growing **economy needs debt capital markets to finance investments that are either too long or too risky for the traditional banks.**

India's banking (and NBFC) system has long been toying with a Lehman moment culminating into series of defaults over the couple of years. The PSU banks have almost 70% of the loan stock and they have gone on a non-lending spree, given the risk aversion. The NBFCs have been robbed of their confidence and have been starving for money to survive, specifically down the credit curve. Combined banking system has about 16% of loans classified as NPLs. All that misallocated lending would have been less probable if companies had bonds outstanding: even the idlest banker will dither to lend to a company if its bonds are trading at a significant discount. Such price-signalling requires an activity level in the debt capital markets – much higher than what it is at at-present.

Debt capital markets in India (only 17% of India's GDP, total debt is about 80% of the GDP) are highly skewed towards sovereign and PSU debt. The investor class is also fairly defined which has not changed much, barring the fact that the central bank has become a significant holder of the Indian debt. The foreign holdings in Indian sovereign debt are a meagre 2% as compared to 30%-40% for economies like Malaysia or Indonesia. Although it is pleasing to see the government continues to take steps to improve foreign participation in the Indian debt markets via inclusion in bond indices, relaxing investment limits, creating an infrastructure for bond trading etc.; however, implementation remains a massive challenge. This is the most opportune time to attract foreign debt investments in India as its debt ratio is among the lowest in emerging markets and current account deficit remains comfortably financed. The Federal Reserve's almost zero interest rate stance will help spur inflows to India.

Well-developed capital markets also provide an opportunity for the economy to benefit at the macroeconomic level by support it gets in transmission of monetary policy measures. The Central bank has always found it difficult to pass on the low rates down the credit curve let alone in a timely manner. A liquid and deep bond market would have certainly aided the lower rated, solvent firms to reap the benefits of a low rate even in the absence of bank credit. Routine lenders clearly do not have this risk appetite and to come out of this pandemic, getting to the $5 trillion mark, it is imperative that the entire spectrum and not the only bet rated ones gets the necessary funding to grow.

For investors and savers, capital markets can offer more attractive investing opportunities—with better returns—than bank deposits, depending on risk profile, liquidity needs, and other factors. Further, with a wider range of securities and instruments offered, capital markets can help investors diversify their portfolios and manage risk. This is particularly important for institutional investors, including pension funds and insurance companies.

There are multiple challenges in developing the debt capital markets which need to be addressed prudently. A robust and an investible bond market needs clear regulation, market access, investor demand and improved benchmarks.

Indian regulations have to be simple and understandable in order that we get a developed bond market. Presence of multiple regulators with separate priorities is hindering the markets' growth and its reform process. We need to have a common regulator with a common goal to get a stable and liquid bond market.

Market access is again a sub-set of the regulation impasse. The IRDAI or the PFRDA have certain norms for the firms which limit their access to the lower rated papers and gives rise to passive investment management. We learn from history that rating alone should not be a criterion for investment and pitfalls of the same. Different platforms like CCIL, Stock exchange etc. only exacerbate the situation.

Investor demand has to be created. Nurturing domestic investible asset pools via pensions, insurance, and savings vehicles for individuals to deploy into capital markets is critical for local sustainable capital market development. Pension reform, development of the local insurance industry, and an increase in household savings should be part of a comprehensive capital market development program.

The policy makers need to be applauded for the launch of the maiden Bharat Bond ETF. This will go a long way in ensuring transparency and retail participation in the bond markets. The global bond ETF market is expected to boom to $2 trillion by 2024 from the current levels of $1.3 trillion. India as a nation should see this as an immense opportunity to grow its bond markets. Much of this growth has to be fuelled by retail participation and diversifying the offerings to Gilts, SDLs, Pvt Companies' papers o sectoral focussed schemes etc., managed as efficiently as demonstrated by Bharat Bonds ETF. Traditional fixed-income investors have started to welcome bond ETFs in the outcome of March's market turmoil where liquidity was zapped and individual securities did not change hands for days together and spreads widened at unaffordable levels till RBI came out in a preponed credit policy announcing measures to calm down the market by rate cuts & liquidity injections. Bond ETFs kept trading throughout, providing a release valve of sorts and solidifying their place in institutional portfolios. To further the cause, some tax incentives may be offered for investments in the bond ETFs.

With expansion of the economy comes the double whammy of stressed assets. A well-developed and quick resolution infrastructure like the IBC will garner investor interest in lower rated papers. The IBC has been tardy in giving results and demands a lot of improvement in its processes. Examples can be had of countries like Brazil, Russia, China, and United Kingdom who have vehemently reformed the bankruptcy laws and have witnessed a significant growth in their bond markets. A stout resolution process will usher in a positive wave of corporate governance which will boost investor confidence even for corporates down the credit curve.

To conclude, growth needs debt and debt needs capital markets. This, however, is not a linear path as investments and growth happen in stages. Therefore, we need sequencing of policies and starting with getting clean and clear regulations that shall set the path for a thriving debt capital market.