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The impact of monetary policy on corporate bonds in India

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Abstract

We analyse the impact of monetary policy on the shape of the corporate yield curve and credit spread using a macro-finance approach. Instead of estimating the latent factors from the data on corporate bonds, we use market proxies of level, slope and curvature of the corporate yield curve and credit spread. The results demonstrate that while monetary policy has the dominant impact among macroeconomic variables on the entire term structure, it is particularly strong at the short end and on credit spreads. Changes in credit spreads, in turn, also influence monetary policy. The results are robust to alternative identification schemes and have important policy implications for further development of the corporate bond market, particularly in emerging market economies.
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1. Introduction

Corporate bonds are a key constituent of a modern financial sector as it plays a pivotal role in long term financing of an economy. A well-diversified financial system with balanced distribution

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across bank lending and corporate bonds is less vulnerable to a financial crisis (Luengnaruemitchai & Ong, 2005). In this regard, corporate bond market provides effective competition to the banking sector thereby strengthening financial stability. Moreover, active corporate debt markets bring substantial economic benefits and are important for all stakeholders' *viz*. companies, investors, economies and governments. From this perspective, the development of a contemporary regulatory and financial supervisory framework plays an important role in the vibrancy of corporate debt markets (Wells & Schou-Zibell, 2008).

Globally, corporate bond markets have prospered since the Asian economic crisis of 1997 and have started playing a greater role in economic and financial sector development, particularly in advanced economies having market-based financial systems.[2] In most emerging market economies (EMEs), however, the pre-dominance of the bank-lending channel, weak market infrastructure and inadequacy of institutions have inhibited the development of the corporate bond market. This is unfortunate as investors in corporate bonds usually undertake greater due diligence in assessing the viability of projects and are often considered superior to bankers in project evaluation and funding (Hakansson, 1999).

In the Indian context, outstanding corporate bonds amounted to around Rs. 9 trillion (approximately $147 billion) in 2011 constituting nearly 10.5% of Gross Domestic Product (GDP), whereas the proportion of bank loans to GDP is more than triple that figure at approximately 37% (Sengupta & Anand, 2015). In contrast, outstanding corporate bonds are close to 90% of GDP in US where the corporate debt market has long replaced bank financing as a funding source for the corporates; around 34% in Japan and close to 60% in South Korea (BIS, 2012). In terms of size, the Indian corporate debt market was approximately 7% of that of China and 15% of that of South Korea as of 2011 (BIS, 2012) and only about 31% of the domestic government securities market.

In the post-crisis period, as India aims to recalibrate to the high growth trajectory recorded during 2003–2008 (average 8.7%) amidst persisting inflation pressures, there is enormous stress on infrastructure financing which is currently done primarily through budgetary support or bank credit. Given that banks have become more risk-averse since the financial crisis, the resultant funding gap can be bridged by developing a well-functioning corporate bond market. According to the 12th Five-Year Plan (2012–2017), $1 trillion is expected to be spent on infrastructure projects in India. Consequently, infrastructure companies could tap the corporate bond market to raise long-term capital instead of depending on the traditional banking channel which is already overstretched and burdened with rising non-performing assets (NPAs).

In view of the above, a pertinent question to ask is whether monetary policy can influence market activity in corporate bonds. More specifically, is the corporate yield curve and credit spread receptive to policy signals. International evidence suggests that in the post-crisis period, unconventional monetary policy through quantitative easing was expected to reduce the borrowing cost for corporates.[3] Therefore, it is important to understand the effects of monetary policy on the corporate bond market (Guidolin, Orlov, & Pedio, 2014). From this perspective, our paper addresses three questions. First, whether monetary policy shocks are transmitted to the corporate bond market in India. Second, whether such shocks have an impact on corporate yields through a change in the risk-premia. Finally, how the corporate yield and credit spread affect monetary policy.

[2] Goodfriend (2005) argues that more efficient and transparent firms mobilise resources through corporate bonds to lower their effective interest costs.

[3] Minutes of the Federal Open Market Committee Meeting of December 16, 2008, Federal Reserve Board.

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