Quickonomics

March 16, 2020

The yields poser

At times, empirical evidence can swerve from economic theory. That seems to be happening with south-ward bound government security (G-sec) yields in India.

Typically, higher fiscal deficit → higher government borrowings → higher supply of G-secs → lower G-sec prices → higher G-sec yields.

However, despite fiscal deficit being revised up to 3.8% of gross domestic product (GDP) for this fiscal – the highest in four years – compared with 3.3% budgeted earlier, the 10-year G-sec yield has slid ~100 basis points (bps) from 7.3% at the start of fiscal 2020 to 6.3% as on March 13.

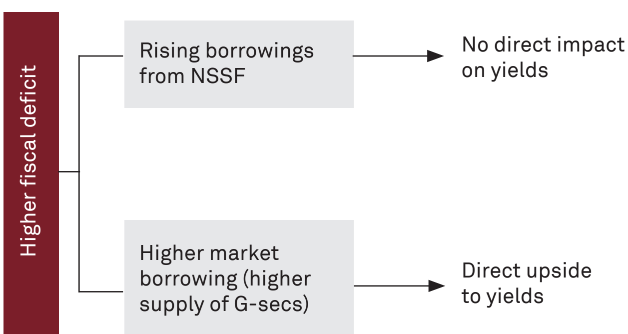
Are yields ignoring fiscal cues? Well, not exactly.

Other factors are dominating, actually. Such as:

1. **Centre is relying less on market borrowings**
   The central government has been borrowing significantly from the National Small Savings Fund (NSSF), a non-market source. That has taken some pressure off G-Sec yields. In fiscal 2020, while net market borrowings rose 16% on-year, that from NSSF rocketed 92%.

   This is not a one-off, either. The share of NSSF in funding fiscal deficit has risen steadily to 31.3% in fiscal 2020 from 1.3% in fiscal 2013, while the share of market borrowings dropped nearly a third to 65.1% from 96.2%.

How government borrows can affect yields differently



Source: CRISIL

2. **The influence of repo rate and crude prices**
   There are some other dominant triggers, too. In particular, we have found that the repo rate and crude oil prices significantly persuade short-term movement in the 10-year risk-free yield.

   A historical analysis using the Vector Auto Regression model suggests a unit[1] drop in crude price can lower yields by at least 8 bps in a month and 16 bps in three months, while a similar reduction in the repo rate can lower yields by 4 bps and 5 bps, respectively.

   And a sharper and prolonged intensity of shock can aggravate this impact.

   Empirical evidence bears this out (see graph on Page 2: *Crude prices and repo rate drive G-sec yields*). In fiscal 2010, the 10-year G-sec yield fell on-year despite the fiscal deficit rising to 6.6% of GDP. During this period, there was also a 16.9% decline in the price of Brent crude oil.

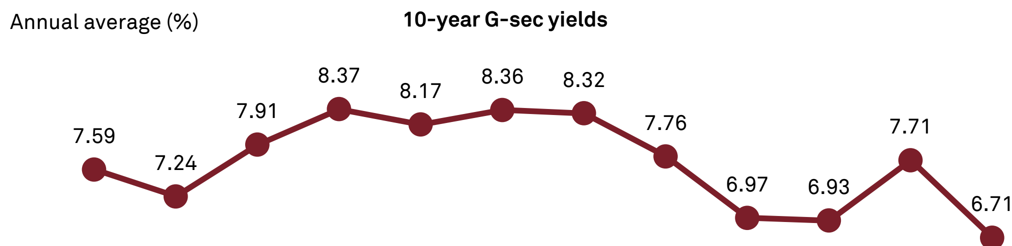
   While fiscal consolidation began in 2013, yields started falling only from fiscal 2015, when the Reserve Bank of India (RBI) began monetary easing and crude prices spun lower.

   In this fiscal to date, a ~51% fall in crude prices and a 110 bps cut in the repo rate have offset the fiscal stress somewhat. And sharp monetary policy easing globally to support demand has pulled down yields. The US Federal Reserve alone cut rates thrice in 2019 and twice so far in 2020, bringing them close to the zero lower bound.

   Then there were unconventional easing measures from the RBI, including Operation Twist (under which it bought 10-year G-secs and sold 1-year G-secs), revamping of liquidity management framework, and introduction of long-term repo operations. All these helped lower yields.

[1] *The estimates have been arrived using an impulse response function. Each estimate can be interpreted as - how a unit shock (of one standard deviation) to the explanatory variable affect yields?*

Crude prices and repo rate drive G-sec yields



		FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20*
Global	Crude oil prices ($/bbl)	84.7	69.8	86.7	114.4	110.5	107.6	85.5	47.5	49.0	57.6	70.2	62.6
	Fed rate (March, %)	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.375	0.875	1.625	2.375	0.125
Domestic	Fiscal deficit (% of GDP)	6.1	6.6	4.9	5.9	4.9	4.5	4.1	3.9	3.5	3.5	3.4	3.8
	Repo rate (March, %)	5.00	5.00	6.75	8.50	7.50	8.00	7.50	6.75	6.25	6.00	6.25	5.15
	CPI inflation (%)	9.1	12.3	10.5	8.4	9.9	9.4	6.0	4.9	4.5	3.6	3.4	4.9

Improving Worsening No change

*Note: *FY20 data is average and refers to data available till mid-March, CPI inflation data is average and FY20 is CRISIL forecast*
Source: World Bank, US Federal Reserve, Budget documents, RBI, National Statistics Office, CRISIL

What to expect in fiscal 2021

Fiscal stress will push up borrowings. But other moving parts could yet again have more bearing, and limit upside in yields.

And a low interest rate environment would create the room for more market borrowings.

This time, market borrowings will be more...

Contrary to fiscal 2020, the Centre is expected to rely more on market borrowings in fiscal 2021. Net market borrowing is budgeted to increase 7.4% on-year to Rs 5.4 lakh crore, and increase its share of fiscal deficit to 67.3%.

In contrast, borrowings from NSSF are budgeted to be flat at Rs 2.4 lakh crore. Supply of bonds could also be higher due to increased borrowing by states, where, too, the fiscal position is tight.

...but other factors will carry more weight

Crude prices, central bank actions and inflation would remain favourable over the next few months.

CRISIL Research foresees Brent crude price dropping to $35-40 per barrel in calendar 2020, compared with $64 in 2019. Rising risks from the coronavirus disease (Covid-19) – now declared a pandemic – will subdue global economic activity and therefore crude oil prices.

The discord among producers has also impacted crude oil prices.

Global interest rates are also softening. The US Fed, Bank of England, Reserve Bank of Australia, and Bank Indonesia have started to cut rates to fight the downside risks to demand from Covid-19.

That, and the expectation that inflation in India will cool in the second half of fiscal 2021, give the RBI the leeway to cut its repo rate once again.

So, between the push of fiscal stress and the pull of lower crude oil prices and interest rates, expect the latter to sway yields next fiscal.

That will come in handy if the government decides to borrow more to cushion the blow to demand from Covid-19.

Quickonomics will take a look at data points and try to explain their significance.

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