Quickonomics

January 09, 2020

The long and short of term premium

Term premium – or the difference in the yields on 10-year government security (G-sec) and short-term treasury bills (T-bill) – has hovered above 100 basis points (bps) for two years now.

And for the past three months or so, this 'spread' has surged to more than 150 bps. That compares with the 'trend' of 40-50 bps[1] seen earlier.

There are two reasons for this:

1. Ascending 10-year G-sec yield, because of high central and state government borrowings and limited investor appetite (high supply of G-secs→ lower prices→ higher yields)
2. Descending short-term yields, because of monetary easing and the current surfeit of liquidity

Interestingly, the term premium has deviated from the trend only twice in the past decade, and both times because of external shock.[2] It then reverted to type reasonably quickly.

This time around, home-grown stress has been the cause, and there seems to be nothing around to help reverse the course. Especially since the Centre and the states are not just borrowing more, but for longer, too.

Why should all this worry us?

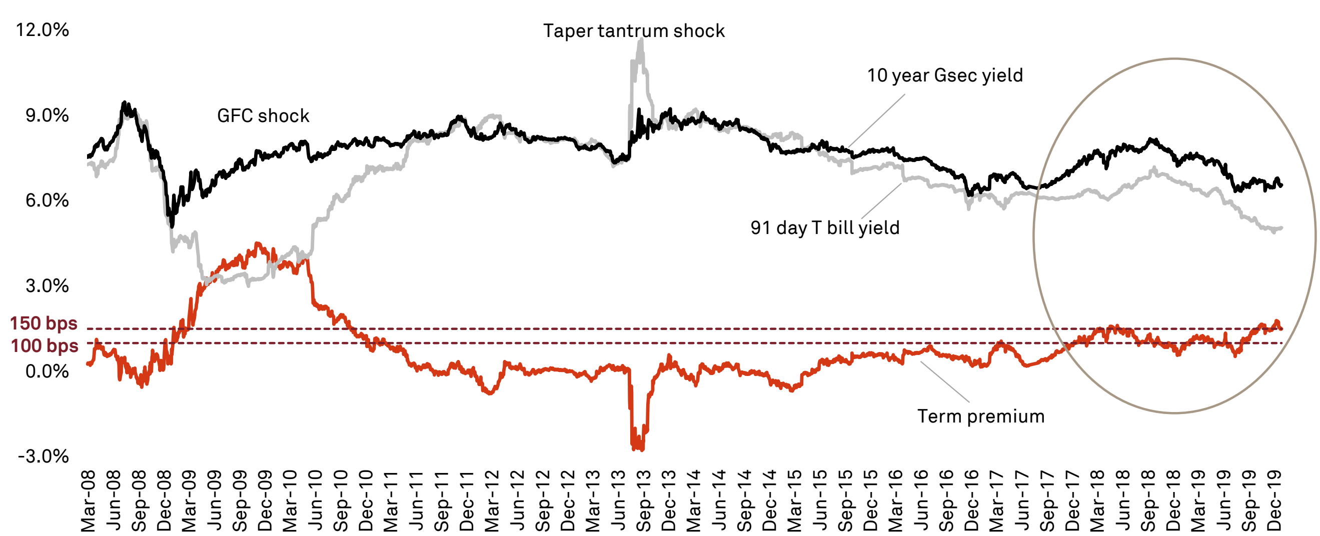
When G-sec yields rise, borrowings become costly for the government. That, in turn, causes interest rates in the market to rise, too.

Exactly what we don't want when monetary policy is trying to lower interest rates to fight the economic slowdown!

Put another way, monetary policy transmission isn't happening to the extent desired – but that's getting ahead of our story.

A not-so-standard deviation: 10-year bond yields have stayed stubbornly high

Term premium (10 year bond minus 91 day Tbill)



Source: Reserve Bank of India (RBI), CRISIL

[1]This is not accounting for the two shock periods of the global financial crisis (GFC) and 'taper tantrum', and the period since December 2017.
[2]Term spread was, on average, 290 bps in the aftermath of the GFC - when repo rates came down sharply but 10 year bond yields rose, as fiscal deficit surged. Spreads were zero to negative around the taper tantrum period, when the repo rate was range bound but there was fiscal consolidation being pursued.

Examining the channels

The Centre's gross market borrowing has surged 24% this fiscal. Total 10-year issuances are also 1.5 times the value borrowed last fiscal, when the Centre had issued more short-term papers.

Similarly, borrowings by states (by issuing securities called 'state development loans' or SDLs) rose 18-19% per year in fiscals 2019 and 2020, again through longer-tenure gilts.

There are three reasons for this:

1. In the aftermath of the global financial crisis, states were allowed an increase of 0.5% of gross domestic product (GDP) through market borrowing. Reissuance of SDLs to finance redemption of previously issued papers, therefore, have increased
2. Beginning fiscal 2017, states shifted from National Small Savings Fund (NSSF) loans to SDLs to fund their deficit. About 90% of the fiscal deficit of states are now financed by market borrowings (versus 60% 4-5 years ago).
3. The fiscal position of states deteriorated (because of issuance of Ujwal Discom Assurance Yojana bonds, farm loan waivers, and economic slowdown), which has forced them to borrow more.

Some other internal and external macroeconomic factors have also pushed the 10-year G-sec yield up. However, higher government borrowings has been, to twist a Hollywood flick title, the constant hardener.

Investors prefer (state) bonds

SDLs have also been increasingly favoured on the street. Their share of total government securities held by top investors (banks, insurance companies and provident funds) rose to 37% in fiscal 2019 from less than 30% some 4-5 years ago. Needless to say, the proportion of central government securities held have declined by that extent.

The implicit sovereign nature of SDLs and their 60-65 bps higher yields on average in the past few years, compared with the 10-year G-sec, clearly make them more attractive.

Twists, but no turn

All that's why, despite the monetary easing by the Reserve Bank of India (RBI) and its 'Operation Twist I and II[3]' in December, high government market borrowings and investor preference for SDL have kept the 10-year G-sec yield elevated.

The two Operation Twists did moderate yields for a bit, but that got pared as oil prices rebounded on rising geopolitical tension.

To recall, since January 2019, the RBI has cut its repo rate by 135 bps and the yield on the 91-day T-bill has closely followed suit. And up to July, the 10-year G-sec yield also fell – by more than 100 bps – only to rebound thereafter.

There's another collateral catch: Small savings scheme rates have also stayed high because they are benchmarked to the 10-year G-sec yield. That, in turn, means banks can't cut deposit rates by much, since they compete with small savings schemes for investor money to do business.

Ah, the vicissitudes of monetary transmission!

Quickonomics will take a look at data points and try to explain the reasons behind it

---

[3]The RBI conducted two special open market operations (OMOs) in December where in each of the tranches it purchased 10-year G-secs worth Rs. 10,000 crores. Against this it sold 1 year G-sec worth Rs. 6,825 crores in the first tranche and Rs 8,501 crores in the second tranche. This is being called Operation Twist.

Analytical contacts

Dharmakirti Joshi
Chief Economist
dharmakirti.joshi@crisil.com

Bhushan Kedar
Director - Funds & Fixed Income Research
bhushan.kedar@crisil.com

Dipti Deshpande
Senior Economist
dipti.deshpande@crisil.com

Bhoomika Dattani
Manager - Funds & Fixed Income Research
bhoomika.dattani@crisil.com

Pankhuri Tandon
Junior Economist
pankhuri.tandon@crisil.com

Poorva Pramod Saurkar
Manager - Funds & Fixed Income Research
poorva.saurkar@crisil.com

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Research

CRISIL Research is India's largest independent integrated research house. We provide insights, opinion and analysis on the Indian economy, industry, capital markets and companies. We also conduct training programs to financial sector professionals on a wide array of technical issues. We are India's most credible provider of economy and industry research. Our industry research covers 86 sectors and is known for its rich insights and perspectives. Our analysis is supported by inputs from our large network sources, including industry experts, industry associations and trade channels. We play a key role in India's fixed income markets. We are the largest provider of valuation of fixed income securities to the mutual fund, insurance and banking industries in the country. We are also the sole provider of debt and hybrid indices to India's mutual fund and life insurance industries. We pioneered independent equity research in India, and are today the country's largest independent equity research house. Our defining trait is the ability to convert information and data into expert judgments and forecasts with complete objectivity. We leverage our deep understanding of the macro-economy and our extensive sector coverage to provide unique insights on micro-macro and cross-sectoral linkages. Our talent pool comprises economists, sector experts, company analysts and information management specialists.

CRISIL Privacy

CRISIL respects your privacy. We may use your contact information, such as your name, address, and email id to fulfill your request and service your account and to provide you with additional information from CRISIL. For further information on CRISIL's privacy policy please visit www.crisil.com/privacy.

Argentina | China | Hong Kong | **India** | Poland | Singapore | UAE | UK | USA
CRISIL Limited: CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India
Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com
/company/crisil @CRISILLimited /CRISILLimited /user/CRISILLimited /lifeatcrisil

CRISIL
An S&P Global Company