Falling Bond Yield

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Why in News

Recently, the **Reserve Bank of India's (RBI)** decision to step up purchase of **Government Securities (G-Sec)** under the **Government Securities Acquisition Programme (G-SAP)** led to the **yield on the benchmark 10-year bond falling below 6%.**

> In India, the **yield of 10-year G-Sec is considered the benchmark** and shows the overall interest rate scenario.

Key Points

- **Bond Yield:**
  - Bond yield is the **return an investor realizes on a bond.** The **mathematical formula** for calculating yield is the **annual coupon rate divided by the current market price of the bond**
    - **Bond:** Is an **instrument to borrow money.** A bond could be issued by a country's government or by a company to raise funds.
    - **Coupon Rate:** It is the **rate of interest paid by bond issuers on the bond's face value.**
- **Effect of General Movement of Bond Yields:**
  - Movements in yields depend on trends in interest rates, **it can result in capital gains or losses for investors.**
    - A rise in bond yields in the market will bring the price of the bond down.
    - A drop in bond yield would benefit the investor as the price of the bond will rise, generating capital gains.
- **Reason for Decreasing Bond Yields:**
  - Due to **economic uncertainty caused by Covid-19**.
  - In April 2021, the RBI launched **G-SAP** which has **caused a decrease in G-sec yields** which has continued since then.

- **Impact:**
    - **Better Equity Markets:**
        - A decline in yield is also **better for the equity markets because money starts flowing out of debt investments to equity investments.**

            Equity market: It is a **market in which shares of companies are issued and traded**, either through exchanges or over-the-counter markets. **Also known as the stock market.**
        - That means **as bond yields go down, the equity markets tend to outperform** by a bigger margin and as bond yields go up equity markets tend to falter.
    - **Reduced Cost of Capital:**
        - When **bond yields go up**, the cost of capital goes up. That means that **future cash flows get discounted at a higher rate.**

            Discounting is the process of determining the present value of a payment or a stream of payments that is to be received in the future.
        - This compresses the valuations of these stocks. That is one of the reasons that **whenever the interest rates are cut by the RBI, it is positive for stocks.**
    - **Reduces Risk of Bankruptcy:**
        - When **bond yields go up**, it is a signal that **corporates will have to pay a higher interest cost on debt.**
        - As debt servicing costs go higher, **the risk of bankruptcy and default also increases** and this typically makes mid-cap and highly leveraged companies vulnerable.
- **RBI's Stand:**
    - The RBI has been **aiming to keep yields lower as that reduces borrowing costs for the government** while preventing any upward movement in lending rates in the market.
    - A rise in bond yields will put pressure on interest rates in the banking system which will lead to a hike in lending rates. The RBI **wants to keep interest rates steady to kick-start investments.**

Government Securities Acquisition Programme

- **About:**
    - The RBI, for the year 2021-22, has decided to put in place a secondary market **G-SAP 1.0.**

        It is part of RBI's **Open Market Operations (OMOs).**
    - Under the programme, the **RBI will commit upfront to a specific amount of Open Market Purchases of G-Secs.**

- **Objective:**
    - To **avoid volatility in the G-sec market** in view of its central role in the pricing of other financial market instruments across the term structure and issuers, both in the public and private sectors.
- **Significance:**
    - It will **provide certainty to the bond market participants** with regard to RBI's commitment of support to the bond market in **Financial Year** (FY) 2021-2022.
    - It will **help reduce the difference between the repo rate and the 10-year government bond yield.**
        - That, in turn, will **help to reduce the aggregate cost of borrowing for the Centre and states in FY 2021-22.**
        - **Repo rate** is the rate at which RBI lends money to commercial banks.
    - It will **enable a stable and orderly evolution of the yield curve** amidst comfortable liquidity conditions.
        - **Yield curve:** It is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates.
            - The slope of the yield curve gives an idea of future interest rate changes and economic activity.

Source:IE