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The Economy Observer

Why 10-year yield could fall to 5.5% over next few months

Massive increase in banks' excess deposits could offset higher deficit

- **The benchmark bond yield moved sharply from 6.5% a couple of weeks ago to ~6% last week, before moving back to 6.2% (currently). Was yield of 6%, then, an aberration? Would the bond yield move back to 6.5%? We do not think it likely. We believe the 10-year bond yield could break the 6% level and test 5.5% over the next few months.**
- **In the past, we have worried about fiscal deficit due to the limited availability/supply of funds in the domestic market, also known as domestic savings. However, the situation has now changed dramatically.**
- **With the expectation of a massive rise in fiscal deficit in FY21, there is the fear that a large supply of government securities would push bond yields higher. Although we believe the supply of G-Secs could double to INR11t this year, from the budgeted IRN5.5t, this is only one part of the equation. The higher deficit is likely to be compensated by sharply higher financial savings, extremely weak private credit off-take, and the RBI's continued support.**
- **Our estimates suggest household (net) financial savings could rise to 8.8% of GDP in FY21, from 6.7% in FY20, driven by: a) lower discretionary spending, b) lower physical savings, and c) weak household loan growth. Furthermore, corporate loans could grow only marginally this year (in line with GDP growth). This implies banks' credit-deposit ratio could fall to 72.4% in FY21, from 76.4% in FY20, leading to excess deposits (surplus) at banks worth more than INR8t. This surplus could easily manage the excess supply of government securities, with minimal support from the RBI.**
- **Consequently, we argue that over the next few months the bond market could behave similarly to what was witnessed after the demonetization. The benchmark 10-year bond yield, therefore, could fall below 6%, even testing 5.5% over the next three to six months.**

Eventually, we believe the RBI would either dismantle the reverse repo window or limit the amount accepted under this facility so banks begin deploying the excess liquidity.

Benchmark bond yield has fallen sharply in the last two weeks: The benchmark 10-year bond yield has moved sharply in the past few weeks. From as high as 6.5% a couple of weeks ago, the 10-year yield fell toward 6% last week, before moving back toward 6.15% *(Exhibit 1)*. The key reasons for the plunge in bond yield include: a) market speculation that the RBI intervened in the last two treasury bill issuances, reflected by a surge in the bids ratio *(Exhibit 2)*, and b) the RBI's small step to make it slightly unattractive for banks to park excess capital with the central bank by cutting reverse repo to 3.75%. We believe the RBI would eventually either dismantle the reverse repo window or limit the amount accepted under this facility so banks begin deploying the excess liquidity.

Exhibit 1: 10-year bond yield has moved quickly recently…

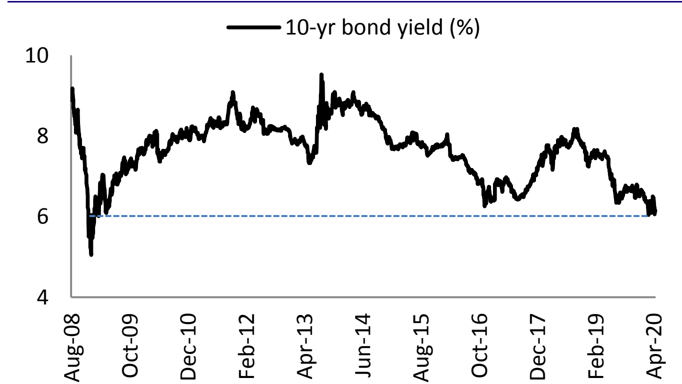
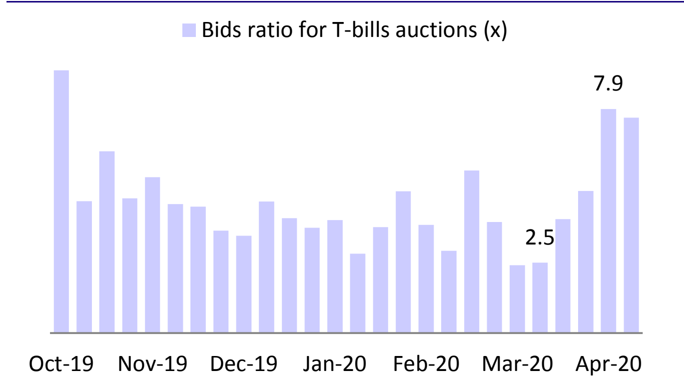


Exhibit 2: …supported by speculation of RBI intervention



Source: Reserve Bank of India (RBI), Bloomberg, MOFSL

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Household financial savings could rise disproportionately this year…: Due to the serious blow dealt to real economic activity, it is inevitable the government would witness a massive receipt shortfall. Therefore, a much higher fiscal deficit is equally inevitable. As we have discussed in detail **here**, the central government's reported fiscal deficit could rise to as high as 7.5% of GDP from the targeted 3.5% of GDP for the year. This includes our expectation of an additional economic stimulus worth 2% of GDP. It means the fiscal deficit could rise to INR15.6t in FY21 (including additional stimulus worth INR4t) from a budgeted INR8t.

Higher deficit is likely to be more than compensated by sharply higher financial savings, extremely weak private credit off-take, and the RBI's continued support.

With the expectation of a massive rise in fiscal deficit, there is the fear that a large supply of government securities would push bond yields higher. We also agree that the total (net) supply of central government papers could double to INR11t in FY21 from the budgeted INR5.5t. This is, however, only one part of the equation. Although the supply of government securities would rise sharply this year, it is also important to understand the dynamics of the demand side of the equation. In this note, we argue that a higher deficit could likely be more than compensated by sharply higher financial savings, extremely weak private credit off-take, and the RBI's continued support.

In the past, our readers know we have **argued** against any fiscal stimulus due to the limited availability/supply of funds in the domestic market, also known as domestic savings. Not only was the demand for a consumption-boosting stimulus misplaced, but the balance between the availability of domestic funds in the economy vis-à-vis demand for funds by the public sector was also totally unsustainable. However, the situation has now changed dramatically.

We forecast nominal GDP could grow ~2% this year, implying that private final consumption expenditure (PFCE, which accounts for ~60%) is likely to grow at a similar pace. While investments would plummet this year, faster growth in government consumption expenditure, and lower external trade deficit would help support GDP growth.

Our estimates suggest household (net) financial savings could rise to 8.8% of GDP in FY21, from 6.7% in FY20, and gross financial savings to 13.2% of GDP this year, from 11.1%.

With lower GDP growth, household income growth is also likely to suffer. Therefore, it is very difficult to make a case for higher household savings, or higher gross domestic savings. Nevertheless, it is almost certain that household financial savings would rise disproportionately this year. There are at least three reasons for this: a) lower discretionary spending, b) a plunge in physical savings, and c) very weak growth in household liabilities. Our estimates suggest household (net) financial savings could rise to 8.8% of GDP in FY21, from 6.7% of GDP in FY20, and gross financial savings (GFS) to 13.2% of GDP this year, from 11.1% *(Exhibit 3)*.

Although headline savings data is available up to FY19, the breakup of household GFS is available only up to FY18. There are five main categories where households can park their financial savings: banks, insurance, pension/provident funds, currency, and others (equities, debt, and non-bank deposits). Nearly 35–40% of household GFS are parked in banks, with another 20% each in insurance and pension/provident funds. Currency in hand accounts for another 15%, while the remaining options make up for the remaining 10% of household GFS.

Exhibit 3: Household financial savings may surge in FY21

Economic variable	Unit	FY16	FY17	FY18	FY19	FY20E	FY21F
Nominal GDP	INR b	137,719	153,917	170,983	189,712	200,957	204,976
	% YoY	**10.5**	**11.8**	**11.1**	**11.0**	**5.9**	**2.0**
Nominal PFCE	INR b	81,264	91,265	100,908	112,540	122,715	125,558
	% YoY	**12.1**	**12.3**	**10.6**	**11.5**	**9.0**	**2.3**
	% of GDP	**59.0**	**59.3**	**59.0**	**59.3**	**61.1**	**61.3**
Personal disposable income	INR b	107,817	119,701	132,200	148,923	158,054	161,455
	% YoY	**9.5**	**11.0**	**10.4**	**12.6**	**6.1**	**2.2**
Household savings	INR b	24,750	27,871	32,773	34,468	34,766	34,414
	% of GDP	**18.0**	**18.1**	**19.2**	**18.2**	**17.3**	**16.5**
Net financial savings (NFS)	INR b	11,108	11,460	13,230	12,302	13,393	18,027
	% of GDP	**8.1**	**7.4**	**7.7**	**6.5**	**6.7**	**8.8**
Gross financial savings (GFS)	INR b	14,962	16,147	20,610	19,957	22,249	27,063
	% of GDP	**10.9**	**10.5**	**12.1**	**10.5**	**11.1**	**13.2**
Currency in circulation	INR b	2,005	-3,165	4,708	2,921	3,514	4,118
Bank deposits	INR b	6,224	9,386	6,502	7,423	7,997	9,897
Insurance	INR b	2,642	3,543	3,504	3,765	4,288	5,161
Pension/provident funds	INR b	2,907	3,252	3,679	3,820	4,237	5,166
Others	INR b	1,184	3,138	2,222	2,020	2,210	2,710
Financial liabilities	INR b	3,854	4,686	7,381	7,655	8,856	9,036
	% of GDP	**2.8**	**3.0**	**4.3**	**4.0**	**4.4**	**4.4**
Physical savings	INR b	13,176	15,946	19,128	21,808	20,873	16,088
	% of GDP	**9.6**	**10.4**	**11.2**	**11.5**	**10.4**	**7.8**

E = Estimates, F = Forecasts

Break-up of GFS is available only up to FY18, FY19-FY21 are our estimates

Source: Central Statistics Office (CSO), RBI, MOFSL

According to our estimates, household GFS could rise to INR27t (or 13% of GDP) this year from INR22.2t (or 11% of GDP) in FY20. Assuming ratios remain unchanged, households' bank deposits could increase to INR10t in FY21 from INR8t last year, insurance premiums and pension/provident funds could increase to INR5.2t each from around INR4.3t, and currency holdings could rise to INR4.1t from INR3.5t. Savings in other options could also rise to INR2.7t from INR2.2t *(Exhibit 3)*.

Almost three-fourths of household GFS are parked in banks, insurance, and PFs, all three of which are the major investors in (or captive market for) government securities.

It does not matter whether households decide to park a higher portion in banks instead of insurance companies or the share of provident/pensions funds falls in favor of bank deposits. Broadly, we argue that almost three-fourths of household GFS are parked in banks, insurance, and PFs, all three of which are the major investors in (or captive market for) government securities. Currency and other options make up only about a quarter of total GFS.

…which could lead to massive rise in banks' excess deposits: Assuming households account for ~95% of all incremental deposits in the banking system, up from 70–80% in the past two years, banks' deposit base would increase by INR10.4t, implying growth of 7.7% in FY21. While deposit growth appears low, it needs to be understood in conjunction with credit growth. With economic activity plummeting, credit demand would also fall rapidly. Historical data suggests the simple correlation coefficient between credit and GDP over the past decade is about 0.90x. Based on a similar ratio, we assume credit would grow in line with nominal GDP this year. In other words, while deposits could grow ~8%, credit/loan growth could be under 2%, as against our estimate of 2% nominal GDP growth in FY21.

Banks' credit-deposit ratio could fall to 72.4% in FY21, from 76.4% in FY20, implying excess deposits of INR8.4t this year.

As a result, banks' credit-deposit ratio would fall to 72.4% in FY21 (under the Base Case scenario) from 76.4% in FY20. Thus, while banks' deposit base would increase INR10.4t, credit would grow just INR2.1t. What would banks do with the funds in excess of INR8t? They would have two options: a) to park it with the RBI at the reverse repo window, like currently, or b) to invest the capital in government securities.

As we have pointed out earlier as well, we believe the RBI would completely temporarily dismantle the reverse repo facility (or significantly reduce the interest rate on the facility) or limit the amount accepted under this window to say 1% of NDTL (net demand and time liabilities), totaling around INR1.4t. In any case, banks would have no other option but to invest the excess deposits of at least INR7t in government securities.

Exhibit 4: Higher G-Secs supply could be offset by banks' excess deposits

INR b	FY17	FY18	FY19	FY20#	FY21		
					Worst	Base	Best
New supply of central G-Secs	**3,785**	**4,858**	**5,242**	**6,212**	**9,000**	**11,000**	**13,000**
Scheduled Commercial Banks (SCBs)	**917**	**3,168**	**815**	**1,660**	**8,000**	**7,000**	**6,000**
SCBs' incremental deposits	10,188	6,826	10,933	10,185	10,938	10,418	9,897
SCBs' incremental credit	2,196	6,299	9,638	5,953	-2,074	2,074	5,185
SCBs' excess deposits	7,074	-2,641	479	2,572	5,013	1,343	-1,289
Insurance companies (ICs)	**1,191**	**1,433**	**1,732**	**1,898**	**2,064**	**2,064**	**1,961**
Provident/Pension funds (PFs)	**353**	**98**	**66**	**100**	**50**	**100**	**150**
Foreign institutional investors (FIIs)	**80**	**614**	**-443**	**-334**	**-1,000**	**0**	**500**
Mutual Funds (MFs)	**-216**	**-193**	**-332**	**820**	**-500**	**0**	**500**
Reserve Bank of India (RBI)	**1,092**	**-924**	**2,766**	**1,292**	**-114**	**1,136**	**2,989**
Others*	**368**	**662**	**638**	**777**	**500**	**700**	**900**

Actual data available up to December 2019; full-year data are our estimates

* Including Co-operative banks, Non-bank primary dealers (PDs), Financial institutions, Corporates, and Others (including state governments)

Source: RBI, MOFSL

Under the Base Case scenario, the RBI only needs to buy G-Secs worth INR1.1t, lower than in the last two years.

With minimal RBI support, higher bond supply could be largely absorbed by banks' surplus…: Besides, we assume insurance companies would invest 40% of their additional premiums (similar to those in the past few years), amounting to INR2.1t, from households into government securities. Furthermore, if FIIs and MFs fail to buy, PFs buy only about INR100b, and other holders buy similar to what they have in the past few years, the RBI would need to buy G-Secs worth just INR1.1t, lower than that in the past two years. Considering foreign capital inflows would not be great this year, the RBI could easily manage base (or high-powered) money supply (M0) with G-Secs purchases of around INR1.1t.

Under the 'Worst Case' scenario, if the government delivers lower-than-expected economic stimulus (just ~1% of GDP, or INR2t), weaker economic activity (say, decline of 2% in nominal GDP) would lead to even higher surplus with banks; in this case, even if FIIs/MFs are the net sellers, the RBI does not need to buy any G-Secs.

Under the 'Best Case' scenario, if the government announces economic stimulus worth INR6t (~3% of GDP), better economic activity (say, 5% growth in nominal GDP) would lead to higher credit growth and lower surplus with banks. Even with net buying from FIIs/MFs, the requirement of RBI support would increase to almost INR3t, similar to that in FY19.

We believe bond yield could fall below 6% and test 5.5% over the next few months.

…leading to lower bond yield: Therefore, under the Base Case, and Worst Case, scenario, a higher supply of government securities could be easily absorbed using banks' increased surplus (or excess deposits) and through minimal RBI support. Consequently, we believe bond yield could fall below 6% and test 5.5% over the next few months.

What if, in the most unlikely scenario, the RBI does not make any changes to the reverse repo window and banks continue to park excess deposits with the central bank? Well, the RBI would have to play the role of the banks, using the funding available at 3.75% to buy government-dated securities at 6%. Would this not be the best possible arbitrage for the RBI? Moreover, if the banks were to miss on this, would it not be the single largest lost opportunity for them?

With excess deposits worth INR7t generated by banks in the past few weeks, it is only a matter of time until either the RBI forces the banks to invest, or they realize this huge opportunity in front of them on their own accord. This is similar to what happened during the demonetization. Even then, banks parked around 4% of NDTL with the RBI on a daily basis, and bond yield fell from 6.9% to 6.3% over the three-month period before the 2017–18 Union Budget was presented on 1st Feb'17. We think a similar story could play out this time too. However, since this cycle is likely to be more durable than the demonetization episode, the effects could also remain for a longer period.

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