

Tightening India-US 10-year bond yield spread puts ₹ under pressure

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Mumbai, 17 August

One of the key factors contributing to the decline in the value of the rupee against the US dollar is the tightening yield spread between the 10-year India government bond and the US government bond.

The yield on 10-year Indian government bonds is now only 295 basis points higher than that of US 10-year treasury bonds, the lowest since January 2007. Lower spread means lower incentive for foreign investors to invest in rupee assets, which adversely affects foreign capital inflows into the country and weighs on the rupee-dollar exchange rate.

For comparison, the yield spread was 4 per cent or 400 basis points at the end of August 2022, and it had been 595 basis points on average in



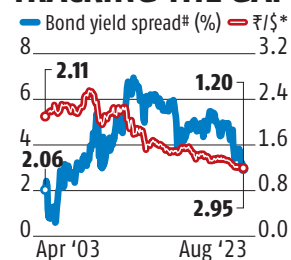
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the last 10-years.

The benchmark bond yields in India are just 6 basis points in the last 12 months, from 7.19 per cent at the end of August 2022 to 7.25 per cent on Thursday. In the same period, the yield on 10-year US government bonds was up 111 basis points from 3.19 per cent in August last year to 4.3 per cent on Thursday, according to Bloomberg data.

The bond yields in emerging markets like India are typically higher than in the US to compensate foreign investors for the higher macroeconomic and political risks associated with investment in emerging markets. Historically there is a high positive correlation between the yield spread in 10-year India and US treasury bond rupee-dollar exchange rate.

TRACKING THE GAP



#India 10-year vs US 10-year bond yield spread (%)
*Price of ₹100 in US dollar, latest data as on Aug 17
Compiled by BS Research Bureau Source: Capitaline

The higher yield spread has translated into a higher or stable exchange rate of rupee against the US dollar, while the depreciation in the value of rupee has always been accompanied by a decline of the spread on bond yield.

For example, the rupee has steadily lost 45 per cent of its value against the US dollar since the beginning of 2011.

In the same period, the

yield spread was down by 185 basis points or around 38 per cent from 4.79 per cent in January 2011 to 2.95 per cent now. In the same period, the INR/USD exchange rate is down from \$2.18 per ₹100 to \$1.2 per ₹100 now.

In contrast, the rupee had appreciated by nearly 20 per cent against the US dollar between 2003 and 2007 as the yield spread between India and US bond yields was up nearly 200 basis points from around 2 per cent in April 2003 to 4 per cent in January 2007. The rupee had once again appreciated against the US dollar in 2009 and 2010 as the bond yields in India have risen faster than that in the US, leading to a rise in yield spread.

In comparison, there was a steady depreciation in the value of rupee since the middle of 2011 along with a decline in the bond yield spread between India and the US.