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RBI Working Paper Series 2:
RBI Working Paper Analyses the Factors Determining Yields in G-Secs

The Reserve Bank of India today placed on its website a Working Paper titled "Public Debt Management in India and Related Issues" under the RBI Working Paper series*. This paper is authored by L. Lakshmanan and R. Kausaliya of the Internal Debt Management Department of the Reserve Bank of India.

The paper empirically examines the effects of sudden shocks in availability of liquidity and the cost of such liquidity in the yield movement of G-Secs in the primary market. Impulse response function under unrestricted VAR framework reveals that when a positive shock is given to the liquidity, in a deficit liquidity phase, the bond yield gradually declines and thereafter stabilises at a level lower than the level before the shock was effected. Shock to the repo rate has positive and immediate impact on the yield of securities with all maturities. Furthermore, expectation of increase in repo rate has significant and immediate positive impact on the yield. The variance decomposition analysis and the two mean t-test also corroborate the findings. Overall, the availability of system liquidity and the cost of such short term fund are also significant factors that determine the yield of the G-Secs in the primary market.

This paper also traces the evolution the Public Debt Management (PDM) in India, in particular the market borrowings and related issues and developments over the years. The PDM in India has clearly traversed from a passive system to a market driven process with developed institutions, instruments, widespread investors, intermediaries for market making and efficient market infrastructure. One of the objectives of PDM is to minimise the cost of borrowing over the medium to longer term. Towards this objective, market factors, both long and short term, affect the bond yield. Though the bond yield is determined broadly by ruling interest rate, expected liquidity risk, repayment risk, market conditions, economic prosperity and long term perspective on the inflation expectations, sudden shocks in short term factors like availability of liquidity (fund) to invest in bonds and the cost of such liquidity play a major role. A well-balanced approach aimed at addressing the issues and challenges with innovative procedures, policies and appropriate product-mix with efficient market infrastructure would make the PDM structure and strategies more robust.

* *The Reserve Bank of India introduced the RBI Working Papers series in March 2011. These papers present research in progress of the staff members of the Reserve Bank and are disseminated to elicit comments and further debate. The views expressed in these papers are those of authors and not of the Reserve Bank of India. Comments and observations may kindly be forwarded to authors. Citation and use of such papers should take into account its provisional character.*

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