

Why bond yields are staying high

THE CATALYSTS. Fears of inflation going up, burden of subsidies and expectations of tight monetary policy are factors



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High bond yields are currently a global phenomenon. The rise in sovereign bond yields is no longer limited to an inflation premium. Across major economies, long-term government bond yields have remained elevated even as inflation has eased from recent peaks. The persistence of relatively high yields in the US, the euro area and Japan suggest that investors are increasingly looking beyond the next central bank decision and paying greater attention to debt dynamics, borrowing requirements and duration risk.

In India too, high sovereign yields pose multiple concerns. Interest payments are the biggest item of government expenditure, consuming about 37 per cent of total revenues. The private investment cycle, which has gathered momentum only recently, may be short-lived if the borrowing costs remain high following elevated risk-free benchmark yields. As households' debt-to-GDP ratio is already high and the overall growth outlook is weakening, consumers may have to prune their non-housing retail loans at high cost. This has been a major source of income for banks. High sovereign yields cast a shadow on a possible economic slowdown. Against the backdrop of global debt market repricing, we reflect on both global and Indian experience to understand why sovereign bond yields remain stubbornly high.

THE YIELD STORY

While the benchmark yield differential between the US and India has been significantly compressed, the Indian debt market tells a different story, somewhat unique to domestic market conditions, particularly after the dollar deluge due to large FCNR(B) deposit mobilisation by authorised dealers (ADs) under the special swap scheme. The Indian government continues to borrow at a relatively high real interest rate compared to many developed countries (see Table). India's benchmark yield differential over the policy rate also remained high *vis-à-vis* other countries.

Most of the developed countries could not bring down sovereign yields in the post-Covid period. Debt-to-GDP ratio remained historically high in many developed countries. On top of it, central banks have increased policy rates in response to rising inflation expectations. Geopolitical risks also contributed to the risk premia.

Country-wise real yield and spread over policy rate (%)

Country	Latest policy rate	10-year govt bond yield	August CPI inflation	Real 10-year yield	Yield minus policy rate
US	4	5.17	3.4	1.77	1.17
Euro Area	2.65	4.01	3.2	0.81	1.36
UK	3.75	5.36	3.1	2.26	1.61
Japan	1.25	3.07	2	1.07	1.82
China	3	1.68	0.8	0.88	-1.32
India	5.25	7.11	4.82	2.29	1.86
Canada	2.25	3.93	3	0.93	1.68
Australia	4.35	5.39	3.5	1.89	1.04

Source: Trading Economics

Multilateral institutions like the IMF, World Bank and the BIS have sensitised the potential risks associated with the rising global debt/debt service burden.

India's bond market continues to be shaped by domestic fundamentals. Rising inflation expectations, driven by elevated global crude oil prices, the burden of fiscal subsidies, and market expectations of tight monetary policy, remain important drivers of the yield curve. Since the second half of FY26, banks found it difficult to finance rapidly rising credit demand amid sluggish deposit growth. Part of their excess SLR/LCR holdings was liquidated to finance credit demand. Liquidity conditions remained tight despite RBI's OMO purchases in FY26.

The situation was complicated by RBI's intermittent forex market interventions, which sucked rupee liquidity. Monetary policy transmission slowed due to tight liquidity conditions. Hawkish minutes of the August 2026 monetary policy amid a neutral monetary policy stance also contributed to the hardening of sovereign yields, despite fiscal consolidation. Global developments, such as movements in US Treasury yields and sustained geopolitical conflicts, also influenced domestic yields, particularly through inadequate net capital inflows.

Liquidity conditions have improved significantly after the phenomenal success of FCNR(B) deposit mobilisation under the special swap scheme, along with other capital account liberalisations. System-level liquidity surpassed ₹10 trillion by September 7, 2026. Even after advanced tax payments in mid-September 2026

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and RBI's ₹1 trillion OMO sales, excess liquidity remains around ₹5 trillion. Hence, there is a need to understand why yields remain elevated despite banks being flush with excess liquidity since August 2026. Credit demand may take time to pick up. What is preventing banks from investing in G-secs?

Banks, including other investors, do not hold government securities simply because they offer an attractive yield. Historically, sovereign bonds form an integral part of banks' balance sheets, mostly due to regulatory requirements under SLR and now LCR. The surplus they hold, mostly in the trading book, has already shrunk. Lack of appetite for sovereign bonds has been predominantly due to market risk. Although the share of the trading book is low in the total investment portfolio, banks have suffered losses in recent quarters due to mark-to-market losses. Moreover, as a part of the Basel III capital adequacy framework, the RBI has recently tightened the market risk framework arising out of banks' investments.

POLICY OPTIONS

India's debt dynamics are somewhat better than those of many countries. The government is committed to fiscal consolidation despite a rise in subsidy burden, partly through strategic disinvestment of PSU shares. The RBI is still on a neutral stance, but faces the dilemma of rising inflation expectations and likely growth slowdown due to global headwinds. Keeping enough excess liquidity in the market to indirectly persuade banks to invest in G-secs to moderate yields may depress the weighted average call rate to the SDF rate. Nevertheless, a calibrated approach may be needed for proactive liquidity management. There is no scope for OMO sales to absorb liquidity as yields are moving northward. The best option should be to go for a forex sell-buy swap to impound excess liquidity. The RBI can opportunistically reduce forward forex liabilities. Every rupee created due to the recent FCNR(B) swap need not be impounded. It is not important that only

money market rates respond to the recent excess liquidity; it should transmit to the long end of the market, including benchmark yields. Daily fine-tuning may be conducted sparingly. The 14-day or longer-term VRRR should be the main operating tools for liquidity management.

The RBI need not necessarily match the recent Fed rate hike. The RBI did not reduce the repo rate adequately, consistent with an average retail inflation of 2.1 per cent in FY26. India's policy rate was one of the highest among its peers. The current CPI inflation being predominantly a supply-side phenomenon, the MPC should tolerate it until the upper bound of the tolerance band is breached. One can argue that the recent compression of the yield differential between India and the US may be due to a fall in the retail inflation rate differential between two countries.

Incidentally, the government's supply management has been successful in keeping retail inflation under control so far. The RBI has acknowledged that the underlying inflation rate, excluding food, fuel and precious metals, continued to remain benign (below 3 per cent). Instead of being too hawkish, it is ideal to communicate that shielding the economy from global headwinds is critical. As October monetary policy is round the corner, the RBI has the option to keep the repo rate unchanged and communicate in clear terms that there is scope for monetary policy transmission to long-term yields and lending rates.

India's benchmark yield appears to be at the peak. Banks should evaluate the mark-to-market losses in the September 2026 quarter by holding the same till yields moderate *vis-à-vis* immediate sale of such securities and repent later. If early solutions to the Middle East conflict emerge, crude oil prices will normalise rapidly. Otherwise, it will remain around \$100 per barrel — a new normal which India can handle with the resilience it has acquired.

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