DON'T WORRY, BE HAPPY

The markets are worried, nay, quite terrified by the direction interest rates seem to be taking. And you can hardly blame them as the specter of the Reserve Bank, relentlessly announcing auction after auction, continues to haunt them. ***This paper is the harbinger of good tidings as it strives to prove that interest rates are likely to remain soft with GOI yields being far softer than their current levels.***

the annual budget……

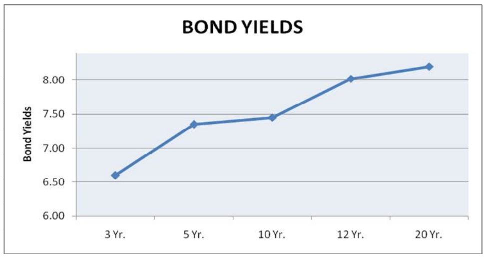
A belated annual budget for 2009-10 shocked investors when it was announced that the Government proposed to borrow nearly 4.50 trillion rupees (Rs. 4,50,000 crores, for the uninitiated) from the market. This happened was just when the participants were beginning to breathe easier in the expectation that the worst was over. This figure was in excess of the previous year 2008-09 by around Rs. 1,75,000 crores – a huge jump by any standards.

the markets react…

Yields bounced up immediately in the aftermath of the announcement but when the RBI clarified that they would support the borrowing program through Open Market Operations (OMO) and that the net borrowing would not be greatly enhanced over the previous year, there was a sigh of relief and uneasy calm prevailed for a few more weeks.

late reactions set in ……

This status quo was rudely shaken when the auction amounts were increased to Rs. 12000 crores and their frequency became weekly. Despite surplus liquidity which the banks had miserably failed to deploy profitably, they started demanding more for the zero risk government security. Auction cut-off prices steadily declined while it became more and more difficult for RBI to push through such auctions successfully. The cancellation of the August 7 auction improved the sentiments but the same came crashing down in the next two to three weeks as more auctions of 12000 crores followed.



followed by the big bang….

Even as the buy-back OMO conducted by RBI on 26 August failed to garner the expected Rs 6000 crores, the Rs 12000 crores auction on 28 August sent the yields soaring with higher than expected cut-offs. The 10-year crossed 7.45% while the

12-year and above securities crossed 8.00% levels. The newly launched interest rate futures further dampened sentiments as they "foresaw" another 20-30 bps of yields hike within the next three months.

But is the situation all that hopeless? We say a resounding NO!!

Looking thru' the much maligned GOI borrowing….

Despite the all the hoopla surrounding this year's borrowing program, few people have cared to go into the actual details of the same. As on 31-08-2009, within five months, RBI had helped GOI place bonds worth an astounding Rs. 2,60,000 crores through dated securities and 364 days T-bills. This represents 58% of the total target amount.

Firstly, that leaves less than Rs. 1,90,000 crores (42%) to be borrowed in the next seven months. This translates into just about 15 fortnightly auctions as against the present weekly auction.

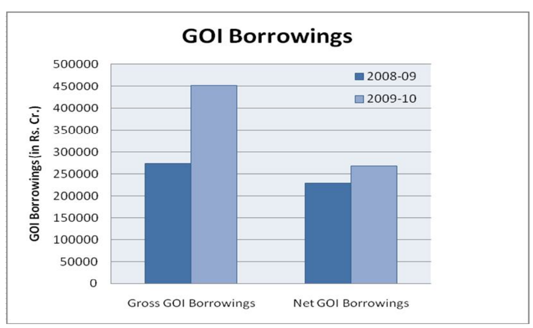
Secondly, notwithstanding criticism from market participants, the RBI is quite correct when it states that the GOI borrowing will not disrupt normal banking credit flows. Just consider the following facts:

1. Against the borrowing of Rs. 2,41,000 crores until 14 August, funds worth Rs. 66,089 crores were released through redemptions of dated securities (Rs. 33,089 crs. of normal bonds and Rs. 33,000 crs. of MSS bonds).

2. Another Rs. 51,000 crores have been provided by RBI through its purchases via auctions as well as direct market interventions.

3. Another Rs. 28,000 crores were sourced from desequestered MSS bonds i.e. unused money lying with RBI was released for GOI use.

Hence, only Rs. 96,000 crores were "net" borrowed from the market as fresh outflows. Interestingly, this is the exact amount by which the GOI holding of banks has gone up during the current financial year. (*Source: RBI weekly statistical supplements*).



Much ado about nothing…..

Thus, we can see that the borrowing has been least disruptive. We may also consider the following facts:

- Banks are already struggling to deploy available funds. Credit growth of 26,000 crores is extremely sluggish and far below the previous year.
- Against this, deposits grew by 2,25,000 crores. **What would the banks have done with all this money if the Government had not been borrowing??!!**
- Banks still have surplus liquidity of over Rs. 1,20,000 crores which they invest at a rate of 3.25% in reverse repo with RBI every day. **So where is the disruption?**
- Market participants bid to buy 12 year g-secs at an auction @ 8.00% but offer to sell the same security to RBI in OMO auction at 7.80%!!! And on top of it, they are disappointed when RBI rejects such bids in the OMO. Can this difference in bid/offer rate of almost Rs.1.50 per Rs. 100 be justified?
- the Government overdraft account with RBI has consistently been running as NIL for the past few weeks which implies that GOI is yet to fully utilize the funds already borrowed; imagine the plight of banks when such funds (including Rs. 28,000 crores of sequestered amount is spent by the Government, further increasing bank deposits and with no known outlet (except g-sec) to deploy.
- even for the balance borrowing program of Rs. 1,90,000 crores, redemptions of dated securities are due for another Rs. 30,000 crores while RBI is also likely to buy at least Rs. 30,000 crores through OMO. If we take into account the unspent Rs. 28,000 cores of desequestered funds, the borrowing program starts looking quite tiny in comparison to the almost Rs. 5,00,000 crores of deposit growth yet to hit the system in the next seven months.

Conclusion

Therefore, we may safely conclude, that GOI borrowings are quite unlikely to have a major impact on the liquidity in the coming months. Since a sudden steep credit growth is also implausible, the supply of bonds will certainly not hit the money markets in a negative manner.

Yields are likely to remain soft with 10 year slated to go below 7.00% within a few weeks and the spreads for higher tenures may compress by 20-30 bps while the spreads for 5 year may further increase as their yields fall even more sharply. However, corporate bond yields may or may not improve depending upon the banks' decision to start investing in them all over again after a longish gap.

It is true that interest rates are not driven by supply and demand alone. But we have used this commentary to exorcise the ghost of so-called "disruptive" GOI borrowing. We will tackle inflation in our next issue. Till then, let us enjoy Bobby McFerrin's hit of 1988 – "Don't Worry Be Happy………"