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Debt Market is Walking the Tightrope

The outlook for the debt market's movement in 2011 will be directly dependent on the liquidity situation and the government borrowings

The debt market risk-adjusted returns in the year 2011 should match or outperform other asset classes like equity or real estate. The prevailing high interest rate scenario is a result of the tight liquidity situation, huge government borrowings, negative real interest rates, and continuous hike in interest rates by the RBI to control inflationary expectations. The liquidity situation is deficit to the extent of ₹1,00,000 crore. This is due to the high cash balance maintained by the central government. The cash balance maintained was ₹92,000 crore as on December 9, 2010. The government cash balance has increased due to the additional amount of ₹70,000 crore received in the 3G auction sale over the estimated amount and ₹24,000 crore received due to IPO/FPO sales of Coal India, MOIL, and PGC.

The government has been the biggest borrower in the debt market to the extent of ₹4,00,000 crore, which has sucked liquidity from the system. The RBI has continuously increased the repo and the reverse repo rates along with hiking the CRR to control inflationary pressures. The CRR has been hiked by 100 basis points and the reverse repo and the repo rates hiked

from 3.25 to 5.25 and the repo rate from 4.50 to 6.25. The core inflation has moderated to the level of 5 per cent and is expected to come down further in the coming months. The month-on-month inflation is expected to be at 8 per cent for the month of November



2010 and the trajectory of inflation is downward due to the base effect and the expectation of food inflation to moderate further due to good harvest.

The tight liquidity situation along with the higher policy rates would dampen the demand conditions in the medium term. Government spending is expected to increase in the last quarter

which should increase liquidity in the system. As inflation levels come down to a more reasonable level of 6 per cent, real interest rates on bank deposits will be positive. This would increase the bank deposits and reduce currency in circulation outside the banking system. All these factors would reduce the liquidity deficit which is around ₹1,00,000 crore to ₹60,000 crore by the month of April.

The one-year bank certificate of deposits which are now trading at the level of 9.25 – 9.50 per cent should come down by 25 to 50 basis points. All the short-end rates which are trading at a spread of 200 to 300 basis points over the government securities rates should compress from these abnormally high levels. The government securities trading in the range of 8 – 8.25 per cent should be range-bound as the borrowing programme for the next year should be around ₹4,50,000 crore. Investors in debt funds in short-term and government securities fund should get high accrual income and the scope of capital appreciation when inflation comes down to the RBI target rate of 5.5 per cent.

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