Public Debt: Current Issues Address by Dr. Y.V. Reddy at Reserve Bank Staff College Chennai on December 27, 1997

Principal Sivaraman and Friends,

I am thankful to Shri Sivaraman for inviting me and giving me an opportunity to meet you and interact with you. He gave me the freedom to choose a topic and I chose public debt because of its great importance to not only the Reserve Bank of India and Governments concerned but also to macro-economic policy in general and to financial sector in particular. In the context of broader economic reform as also financial sector reform, a number of issues on public debt have emerged and need to be debated now. Broadly speaking, the issues relate to: local Government debt, statutory ceiling on debt; limits on Government guarantees; approach to external debt; efficiency of borrowing programme; debt and cash management; debt and liquidity in the financial system; state of debt markets; relevance of Consolidated Sinking Fund; need for a separate Public Debt Office and appropriate regulatory and legislative framework.

What is Public Debt ?

Before addressing each of the issues, let me clarify what public debt means. In a broader sense, public sector debt includes debt incurred by all levels of Governments, Centre, State and local bodies as also Government owned entities. In a narrower and more pragmatic sense (since ownership of entities is getting diversified and changing), public debt refers to debt incurred by Centre, State and local Governments such as Municipalities. Often, when we talk of public debt-GDP ratio or fiscal deficit, we refer only to the debt of Central Government. State Governments do incur debt, but a large part is owed to the Centre and hence, this part will be netted out if we look at total public debt. Yet, because of decentralisation, implicit greater autonomy to States as well as market-orientation, management of public debt at State level is assuming greater importance. In my presentation today, I will touch upon the State level issues also. However, managing debt at local level, is an issue that is just very recently emerging.

Local Government Debt

Local Governments, till recently, borrowed mostly from State Governments or through State Governments, or from public sector financial bodies like Life Insurance Corporation of India. Only recently, they are entering into bond markets. Thus, public debt management by local bodies should really be an agenda for debate. What should be the considerations that govern such bond issues ? How do we integrate them into active debt-markets? What should be their risk weights? Should such bonds be restricted to urban local bodies or should we encourage rural local Governments at District or Taluka/Block level to go for bonds?

The Rakesh Mohan Committee on infrastructure envisages the floatation of municipal bonds to finance, a variety of public projects and services, including power distribution, water supply, waste water management, housing, solid waste management, etc.

The Committee has delineated essentially two types of municipal bonds, on the basis of "how the repayment is secured", viz., the general obligation bonds, where repayments are predicated on the general fiscal strength of the issues, and revenue bonds, where repayments are linked to the revenue generated by the assets created. In view of the poor market image of municipal bodies,

apart from other reasons, the Committee advocates the use of a revenue bond structure in the Indian market.

While some municipalities have already taken recourse to this, I would submit that it is in the interest of financial sector itself to take a view on policy, procedures and approaches that we wish to encourage among local bodies.

Statutory Ceiling on Debt

The issue of fixing borrowing limits for the Central Government by Parliament under Article 292 of the Constitution came up for consideration on several occasions in the past. For example, the Estimates Committee in 1957-58 as also in 1991-92 had pressed for such a ceiling while Public Accounts Committee had advocated a study on this as far back as in 1962. The RBI had addressed this issue in its Annual Reports of 1991-92, 1995-96 and 1996-97. In particular, after the Supplemental Agreement between the Central Government and the RBI in March 1997, discontinuing the practice of automatic monetisation, many intellectuals argued that the objective of such an Agreement is best served only in conjunction with a statutory ceiling on debt. A detailed paper has been prepared on this issue by researchers in the RBI and published in the RBI Bulletin of December 1997 to attract informed and wider debate on the subject. The paper focuses upon international experience, and case for and case against imposing a ceiling. Major issues relevant in this regard are the following:

First, what is the sustainable level of public debt, and what is the rationale for choosing a particular limit for the Indian economy?

Second, should this limit be fixed in terms of a legislative ceiling on public debt? Why a legislative ceiling when debt is implicitly approved along with the Budget? What is the sanctity of a ceiling if it can be changed by a simple majority?

Third, what are the operational issues to place a statutory limit on public debt in India?

Fourth, in the Indian budgetary practice there are three sets of liabilities which constitute debt viz., (a) Internal Debt, (b) External Debt and (c) Other Liabilities. Internal debt and external debt constitute Public Debt of India and are secured under the Consolidated Fund of India. Thus, technically, public debt excludes 'Other Liabilities'. 'Other Liabilities' have grown sizeably over the years and it is sometimes suggested that over and above the liabilities, even 'Contingent Liabilities' of the Government should be considered while placing a limit.

Fifth, whether the limit should be allowed to vary within a year? Under what circumstances can the limit be revised by the Parliament? Even more important is the question whether the limit should be fixed on a year-on-year basis or whether it should be defined on a periodic basis, say, for each five-year plan. In particular, what happens if there are sudden shocks like drought, flood or global developments warranting large unanticipated expenditures and hence debt?

There are some scholars who are against such a ceiling on both theoretical and empirical grounds, as for example, Professor Amaresh Bagchi. It is argued that in theory, it undermines potency of fiscal policy and in practice it may be either ineffective in containing deficits or may be circumvented. Of course, there is also the issue of remedy if the ceiling is exceeded. However, he mentions that the right remedy is awareness of the problem and a consensus on expenditure priorities.

The issue of statutory ceiling on public debt by State Governments has a slightly different dimension. As long as the States are indebted to Centre, they need permission of the Centre to borrow. In effect, their borrowing is determined by Centre which provides loans on its own

account and prescribes the limit on market borrowings. The Reserve Bank puts a limit on Ways and Means Advance also. In brief, a ceiling on a States' public debt is effectively imposed by the Centre. Even so, it may be worthwhile for each State Government to focus on the issue of public debt and debt servicing under Article 293 in advance of budget exercises to lend transparency and address signal concerns.

In this context, personally, I would argue in favour of the proposal hinted in the latest Annual Report of the Reserve Bank, viz., annual ceiling by Parliament (Sate Legislatures) on debt under Articles 292 and 293 of the Constitution before the commencement of budget exercise (instead of implicit approval when budget is finalised for approval on take it or leave it basis) since it imparts necessary flexibility and ensures public awareness.

Limits on Government Guarantees

The total guarantees of Government of India outstanding have increased by forty per cent between 1991-92 and 1995-96 and stood at Rs.65,572 crore as at the end of March 1996. The percentage of external guarantees to total guarantee as of March 1996 is estimated to be about 45 per cent. In fact, as agreements with private power projects come to fruition, the counter guarantee to be provided by the Central Government would increase. Though there is provision for imposing a ceiling on such guarantees under Article 292 of the Constitution, it has not been invoked so far.

The outstanding guarantees extended by each of the major State Governments are broadly in the range of Rs.3,000 to Rs.6,800 crore by end-March 1996. In fact, with large infrastructural projects coming up in the private sector, there is increasing pressure on State Governments to issue guarantees under Special Purpose Vehicles. Among the States, Gujarat had enacted The Gujarat State Guarantees Act, 1963 and had to amend it in 1994 to enhance the eligible amount for guarantee. In the recent meeting of the Reserve Bank with Finance Secretaries of States, many expressed concern over growing pressure on States to give guarantees - particularly by All India Financial Institutions. Some are contemplating legislative action. Some of the bankers have also expressed concern at the inertia of Governments in honouring guarantees already extended. Further, such inertia in prompt honouring of guarantees warrants consideration of giving appropriate risk weight to such guarantees. It has been decided to constitute a Committee with the Reserve Bank to study all the aspects of State Governments guarantees and give a Report in three months.

The questions of a transparent guarantees policy and ceiling on guarantees (with flexibility to take care of the problem of changes due to valuation of foreign currencies) by Government of India are yet to a be seriously addressed.

In my humble view, enactment similar to that made by Gujarat by all State Governments and Central Government along with a transparent statement of policy on guarantees is worth considering.

Approach to External Debt

Under the Constitution, the Central Government but not State Governments, has access to external debt. However, Government of India has not been borrowing externally on commercial terms so far and its borrowings have been limited to external assistance mainly from other Governments and multilateral sources such as IBRD, IDA, etc. Public enterprises could, however, resort to external borrowings on concessional terms also through onlending arrangements with Government, though more recently, intermediation of Government has been dispensed with.

At the end of March 1996, total external liabilities of the Central Government represented only about 8 per cent of total liabilities of the Central Government (21 per cent, if external liabilities are valued at current exchange rates) signifying that only a modest proportion of the gross fiscal deficit has been financed over the years through external debt. Earlier, when Government of India borrowed under external assistance to finance State Government projects, it would pass on a portion to State Governments as additionality to central plan assistance for concerned States on terms as applicable to such central assistance. Now, it passes on the entire amount of external assistance as additionality. Further, States are now permitted to enter into dialogue with multilateral agencies like World Bank.

More recently, the Government has adopted a more liberal approach by permitting foreign institutional investors to invest in dated Government securities. There have also been discussions on the issue of Sovereign Bonds.

FIIs and Public Debt

Foreign institutional investors (FIIs) (both 100 per cent debt funds and funds within the 30 per cent ceiling) have been permitted to invest in both Government and non-Government debt. In respect of Government debt, these FIIs are permitted to invest only in dated Government Securities.

There have been representations for allowing FII investments in Treasury Bills also. This will have to be considered in due course after studying the possible consequences in terms of impact on interest rates, volatility in the flow of funds and its impact on the foreign exchange market.

Sovereign Bonds

We have not made any Sovereign Bond issue so far and our sovereign rating is derived from corporate ratings, especially public sector. Our formal ratings have been around low investment or high non-investment grade. However, empirical evidence shows that our corporates generally are able to obtain credit at terms better than what the official sovereign rating signifies. There is an opinion that India should go in for a Sovereign Bond issue. The proponents argue that a number of advantages would accrue if India issues a Sovereign Bond. First, it could act as a benchmark off which corporates can price their issues. Secondly, it could establish market presence and broaden our investor base in the international markets. Thirdly, it could act as a source of long-term finance for infrastructure projects. Fourthly, it could reduce the cost of borrowings relative to the domestic market. Finally, since international markets are more liquid, it would make roll-overs less problematic and less costly.

However, a few issues need to be sorted out before taking a decision. First, as you may be aware, we have a ceiling for external commercial borrowing. Sovereign Bond is an ECB. The issue that arises here is whether the Sovereign Bond should be carved out of the ECB ceiling. If this be the case, then there could be crowding out of corporate borrowers. Secondly, the real advantage in terms of reduction in cost is indeterminate. Thirdly, there are also issues of timing, market placement, frequency of issue, currency of issue, impact on the fiscal, monetary and external sector, etc.

While there is considerable merit in issuing Sovereign Bond, the above factors will have to be carefully considered before a decision is taken.

Liability Management

A significant portion of the Government's external debt is in the form of borrowings from the multilateral institutions like, IBRD, IDA and the ADB. The external debt of the Government has

been managed all along in a passive fashion in that no active stance is adopted to alter its currency composition and interest rate risk profile, and debt service payments are made as they arise from time to time.

In March this year, a Steering Committee was constituted by the Government for taking necessary policy decisions on the issue of adopting a systematic and active approach towards management of the entire external debt of the Government in general and borrowing from IBRD in particular. The currency choice offer made by the IBRD to its borrowers earlier this year, permitting conversion of currency pool borrowings into single currency exposure terms provided the immediate cause for such an initiative. The Steering Committee was assisted by a Working Group, which went into the technical aspects of the IBRD offer as also the whole gamut of issues concerning active management of external debt. The main recommendations of the Working Group are: (i) Formation of a Debt Management Unit for active management of the external debt, (ii) Establishment of appropriate benchmarks for currency and interest rate risks, (iii) Study of the experiences of countries which have made progress in this area, (iv) Encouraging Public Sector and Private Sector units with IBRD and other forms of external borrowing to have independent capabilities for managing their risk exposures. The recommendations of the Working Group are now under consideration of the Government.

Efficiency of Borrowing Programme

Section 17(1) of the RBI Act enables the Reserve Bank to undertake the business of management of public debt. In terms of Section 20 read with Section 21(2), the Bank has the right and obligation to transact business of management of public debt when entrusted by the Central Government.

Prior to June 1992, the RBI was raising Government borrowing on a fixed coupon basis. As part of financial sector reforms, since June 1992, the RBI has been raising the debt of Central Government at market related rates. New instruments have been floated to provide a variety to investors and to help their portfolio management. With effect from April 1, 1997, a new system of ways and means advances to meet the temporary mismatches of Central Government replaced the earlier system of Ad hoc Treasury Bills. While the concept of Conventional Budget Deficit has been given up, the possible net RBI credit to Central Government during a year is indicated as part of the Budget Document.

It is useful to understand the rationale behind the timing, method of issue, maturity of a specific loan, etc. As you are aware, the Government's borrowing programme is budgeted each year and appears on the receipts side of the Union Budget. While deciding to issue a loan, the Reserve Bank takes into account the cash needs of Government, the liquidity conditions in the market, the market preference for maturity vis-à-vis the future repayment schedule of the Government, and the primary and secondary yield curves. There is also an element of judgement of the Reserve Bank in this process. To elaborate further, if the system is flush with liquidity and prevailing interest rates are low, it makes eminent sense to float a long-term loan. In conditions of tighter liquidity, while deciding on the maturity, the leeway available to the RBI to accept a possible devolvement which is dependent on the monetary situation becomes an important consideration. As I mentioned earlier, beginning 1997-98, the possible net RBI credit to Central Government is indicated in the Budget document. If the net RBI credit to Central Government is well within the limit, the RBI could take up a private placement instead of going to the market, especially if it does not want to disrupt the yield curve. A private placement could also be done to beef up securities for our open market operations. During 1997-98, since there was abundant liquidity in the system and credit was not picking up, we hit the market frequently in order to complete the borrowing programme. We also took up an issue on private placement. You will appreciate that a variety of considerations go into making the borrowing programme efficient and transparent.

The RBI holds the responsibility for the overall borrowing programme of the State Governments. While several reforms in debt management policy have been introduced in respect of sale of Central Government Securities, the sale of State Government loans continue to be on the old pattern and procedures. State loans are for a single and the longest maturity of the Central Government Security issued during that particular year. The coupon is also predetermined. Under the present system, there is no scope for better managed states to access funds at competitive rates of interest. It is recognised that over a period of time, State Governments should move over to a flexible approach to market borrowings in terms of method, timing and maturities. It is essential to evolve a system under which it may be possible for financially sound states to access funds at market rates while ensuring a stipulated level of borrowings in case of less developed States.

This was discussed in the recent meeting between the RBI and the Finance Secretaries of State Governments. It was recognised that given the large inter-state disparities, this changeover should be gradual and cautious. It was agreed in the meeting that State Governments could be given the flexibility to raise a certain percentage of the borrowing programme from the market. The respective State Governments can decide the timing, maturity and coupon. We in the Reserve bank are currently in the process of consultations with Central and State Governments.

Debt and Cash Management

The discontinuance of Ad hoc Treasury Bills and introduction of Ways and Means Advances to the Central Government brought to the forefront, the need for a sophisticated cash management system by the Government and improvements in the debt management techniques by the Reserve Bank. To address these concerns, a Monitoring Group on Cash and Debt Management of the Central Government was set up comprising members of the Government and the RBI. The Group reviews inter alia, the monthly fiscal deficit, progress of borrowing programme, instruments of borrowing, and cash position of the Central Government on an ongoing basis.

This issue was also discussed in the meeting with Finance Secretaries of State Governments. In the light of the experience gained in respect of the Central Government, it was felt that it would be advantageous to conduct a similar exercise for State Governments. To begin with, a symposium will be organised by the RBI to enlighten the State Governments with more professional cash management techniques. The symposium will also discuss the accounting arrangements and the need for improvement in this area, keeping in view the change in technology.

Debt and Liquidity in the Financial System

In formulating and implementing monetary policy, the Reserve Bank places before it a very important aspect, namely, the liquidity management at a shorter term horizon. This facilitates the banking system to provide in a flexible manner the cash and payments needs of the economy. A realistic and timely assessment of liquidity in the system is very essential for timely and effective decision making in money, debt and forex management.

With the basic objective of improving the techniques of liquidity assessment and forecasting, the Reserve Bank has constituted an Internal Working Group whose terms of reference include identifying the nature and sources of data and providing analytical framework and methodology for immediate action plan. The report of the Group is expected in January 1998.

State of Debt Markets

In a Seminar organised by the SBI CAP in September 1997, Governor, RBI had flagged some specific issues for further reforms in the debt market. I had, in my address at Invest India Conference in October 1997, highlighted a number of issues engaging our attention. The agenda

spanned a wide range of issues in the primary and secondary markets and the legislative framework. So, I will not repeat them here. Since then, the Monetary and Credit Policy of October 1997 announced measures to remove operational impediments, foster market clearing mechanisms and widen and deepen the market. The policy announced the intention to preannounce a notified amount in respect of all auctions, keep the non-competitive bids outside the notified amount and resort to the Dutch auction system in respect of 91-Day Treasury Bills, as an experimental measure. The policy also allowed repos to be undertaken in non-Government debt instruments i.e., PSU Bonds that are dematerialised and traded in recognised stock exchanges. Satellite Dealers have entered into agreements with us and two banks have been given in-principle approval for setting up Satellite Dealership. The Reserve Bank has recently permitted the NSE, SHCIL and OTCEI to open SGL II Accounts. Since early December, the Reserve Bank is operating through daily three-and four-day fixed interest, volume- tender repos. In the secondary market, we are both purchasing and selling securities, outright at market related rates. More recently, we have announced the sale of 6 per cent Capital Indexed Bonds.

A number of other issues are currently engaging our active consideration. For instance, the issue regarding the repeal of the Government notification issued in 1969 prohibiting forward contracts in securities is being actively pursued. We have already done considerable spade work in coordination with the market to introduce screen based dealing in money markets and we hope to launch this shortly. While eventually we have to have Treasury bills futures and STRIPS in our market, we should immediately consolidate the reforms already in place.

A more important area, needing urgent attention is the vital role of market participants. Standard practices have to be evolved by the market with regard to the manner of pricing and accounting standards. Code of best practices has to be evolved for repo transactions. I understand the market has recently created a self regulatory body and I am looking forward to active and fruitful interaction with it.

Consolidated Sinking Fund

The system of simultaneous net borrowings and repayments out of fresh borrowings followed by the Governments led to an unsustainable level of gross borrowings of States and the Centre over the years. This resulted in huge repayment liabilities for the Government with steep humps in repayment schedules. This problem would further aggravate if there are additional net borrowings at an increasing rate in the future, especially at higher interest rates with shorter maturities. In this background, it is often argued that there is an urgent need to create a Consolidated Sinking Fund (CSF). The CSF has the objective of breaking the vicious cycle of humps in repayments schedule and the consequential impact upon ballooning of gross borrowing and the expenditure towards interest payments.

In India, it was not the practice of the Central Government to maintain sinking fund in respect of loans floated by it. There was a system of sinking fund only in respect of the State Governments which was made non-obligatory from April 1975. Consequently, such a practice was completely abandoned and repayments are presently provided for out of fresh borrowings.

The Second Finance Commission favoured amortisation of debt from revenue if it can be met out of a real revenue surplus. The subsequent Finance Commissions recognised the importance of amortisation of debt, but only the Ninth Finance Commission recommended an arrangement for amortisation in respect of market borrowings of States. The Tenth Finance Commission while concurring with the Ninth Finance Commission, expressed that the establishment of sinking funds appeared to be desirable as a part of overall fiscal discipline and viewed that the constitution of CSF was relevant both for States and the Centre.

The Reserve Bank has been emphasising the need for setting up of a CSF for both States and the Centre in its Annual Reports since 1992-93, as an institutional solution to the problem of repayments in view of the rising amortisation and interest burden in the budget. The Reserve Bank has also maintained that a part of the revenue receipts need to be earmarked for this fund notwithstanding the traditional view that such a practice should be adopted only in the case of a revenue surplus.

In the recent meeting of the Reserve Bank with the Finance Secretaries of State Governments, the issue of CSF was discussed. The Governments of Rajasthan and Sikkim have shown interest in commencing Consolidated Sinking Fund. Most of the others felt the need to work out more details.

At the request of the State Governments, it was decided that the Reserve Bank will work on pros and cons and detailed modalities of the CSF and communicate them to the State Governments for their consideration.

Separate Public Debt Office

Arrangements for debt management, the world over, vary in nature and they can be broadly categorised into four types, viz., (a) the central bank exclusively undertakes all activities concerned with debt management, (b) where external debt management is handled by Government and internal debt management by the central bank, (c) where Government manages both external debt and internal debt, and central bank functions as an agent to the central government and does book keeping, and (d) where a separate autonomous organisation undertakes both external and internal debt management. New Zealand, Sweden and Ireland are countries which have established separate public debt offices for debt management while in the U.K., this function has been taken over by the Treasury.

The Committee on Capital Account Convertibility (CAC) recommended separation of "debt management" from "monetary management". The Report observed that, "monetary management is often clouded by the monetary authority's concern about the Government's borrowing programme and, therefore, steps should be initiated to separate the debt management policy from monetary management, and to this effect the Government should set up its own Office of Public Debt". An Informal Working Group has, accordingly, been formed in the RBI to examine the Committee's recommendations, in detail. The Group will go into various aspects related to the issue, which comprise objectives of and rationale for separation of debt management from monetary management, identification of a suitable institutional framework for public debt management and the functions to be carved out of the Reserve Bank to be assigned to it, legal implications of separation of debt management from monetary management, etc.

The Informal Group has already held discussions with officials of the Central Government and State Governments and the Report is expected in January 1998. Government and the RBI will have to take a view on convenient institutional and administrative arrangements depending on their exact requirements.

Approach to Regulatory and Legislative Framework

Another area which is attracting attention is the regulation of Government Securities Market. Presently, the primary issuance, servicing and repayment of Government Securities are governed by the Public Debt Act, 1944 and Public Debt Rules, 1946. In addition, Government Securities Manual embodies detailed guidelines for the issue and management of public debt within the framework of Public Debt Act. Reserve Bank is the regulator in this regard. On the other hand, SEBI has a role in regulating and controlling the activities of brokers/dealers as a part of investor protection. The issue regarding extension of SEBI's powers to cover government debt in matters

relating to trading, transfer and settlement procedures including functions of depositories have to be examined, in detail. It would, however, be worth mentioning here that there is no uniformity of structures for regulation of Government securities markets among the OECD countries. In Canada, Germany and Switzerland, there is central government prudential regulation of depository institutions and provincial or state supervision of securities trading. In the U.K., the Bank of England provides prudential regulation of depository institutions, while the Securities and Investments Board supervises in the protection of investors. In the US, the Government Securities Act of 1986 granted the Treasury, authority to promulgate rules and regulations for Government securities brokers and dealers.

The law relating to Government Securities and its management by the Reserve Bank of India is the Public Debt Act, 1944. The present act is no longer relevant since a major proportion of the total liabilities of the Government, viz., other liabilities comprising NSS, Indira Vikas Patra, etc. falls outside the purview of this Act. The procedures prescribed are archaic and pose irritants to the reform process. To cite an example, under this Act, the Reserve Bank has no substantive powers to introduce an instrument of transfer suited to computer environment. There are also other constraints such as those which preclude the RBI from issuing Government Securities in the form of promissory notes in the names of Trusts, non-availability of nomination facility in respect of Government securities, etc. The proposed legislation to be called "the Government Securities Act" is intended to take care of these shortcomings.

Conclusion

Let me conclude by thanking you for giving me this opportunity to bring to your attention the significant developments in the recent past and the wide-ranging proactive initiatives taken by us in the Reserve Bank of India with market participants, State Governments and above all, Government of India. An informed public debate on these issues would enhance our understanding as well as effectiveness.