Managing Public Debt - Issues and Challenges*

I thank the ASSOCHAM for inviting me at the Valedictory session of the Seminar on Managing Public Debt.

During the course of Seminar, various aspects of Managing Public Debt have been discussed. Many suggestions have been made by the speakers. I am sure these suggestions will be sent to Government for consideration.

Practically, all aspects of Debt Management have been discussed in the Seminar. I would, therefore, be supplementing to what has already been said.

Role of RBI

The RBI is the debt manager for both the Central Government and the State Governments. It is also the regulator of Government securities market. RBI also advises the Government at the time of formulation of annual Borrowing Programme. The Public Debt Act, 1944, provides the framework under which government securities are issued and serviced. Under the RBI Act, 1934, RBI is the manager of Central Government debt by statute. RBI manages the debt of state governments on the basis of separate agreements. External debt of the Government is managed by the Ministry of Finance. As a debt manager for the both Central and State Governments, RBI in consultation with the Government, manages the maturity profile, timing of issue, composition of debt and the type of instruments issued. Operationally, RBI deals with the issue, servicing and repayment of government debt.

Debt Sustainability

'Sustainability' of a country's public debt has become an important issue among policy makers, academicians, credit rating agencies and multilateral institutions. Sustainability of debt is critical from the central banking perspective also due to a variety of reasons. A number of central banks advise the government on debt management. Further, an unsustainable debt level is likely to have a major impact on monetary policy objectives. Also the government securities market is important for the domestic capital, money and forex market.

The level and composition of public debt have a significant bearing on a country’s economic development and its ability to withstand shocks and crises. If public debt pre-empts a large part of the savings of the economy, it leads to crowding out of private investment. Excessive borrowing, apart from increasing the tax burden of future generations, can also increase interest rates, thus making private investment more expensive. If the cost of servicing debt accounts for a large part of government revenue, funds available for desirable items like health, education and infrastructure get reduced. It is, therefore, essential, particularly for developing countries, that not only is the level of debt kept within sustainable limits, but its cost, composition and risk profile is managed efficiently.

During the seminar, various aspects of public debt were discussed. Sustainability of public debt was also debated.

We started reforms process in 1991-92. Let us see how various indicators of public debt have behaved since then.

Revenue Deficit (Difference between revenue receipts and revenue expenditure)

As regards Central Government, in 1990-91 the Revenue deficit as per cent of GDP was 3.3. There was improvement for the next few years. Till 1997-98, with the exception of one year (1993-94 - 3.8%), the ratio was below that level and averaged 2.8%. Thereafter, till 2001-02 the ratio averaged 3.9%. For the period from 1991-92 to 2001-02, the average was 3.1%.

In recent years, interest payments have accounted for about 50% of Revenue Receipts of Centre. The ratio has increased from 40.3% in 1991-92 to 50.5% in 2001-02.

As far as the States are concerned, the Revenue Deficit - GDP ratio was 0.9% in 1990-91. Till 1997-98 the ratio was more or less at that level (average 0.8%). For subsequent four years, the average level was 2.6%.

The Fiscal Responsibility and Budget Management Bill, 2000, which is before the Parliament, envisages `Zero' revenue deficit for the Centre by 2006. The Eleventh Finance Commission has put the target at 1% for Centre and 0% for States by 2004. These targets are indicative of future direction.

Gross Fiscal Deficit [GFD = Total Expenditure (including loans, net of recoveries) minus revenue receipts (including external grants) and non-debt capital receipts]

In 1990-91, GFD of Centre was 6.6% of GDP. There was some improvement in the position in subsequent years. The average ratio for the period worked out to 5.0% of GDP. For the last four years (1998-1999 to 2001-02) the ratio averaged 5.5%.

The Fiscal Responsibility and Budget Management Bill, 2000 envisages the ratio at 2% by March 2006. The Eleventh Finance Commission (2000) recommended the ratio at 4.5% for Centre, 2.5% for States and 6.5% combined by 2004-05.

As far as States are concerned, the GFD as a per cent of GDP was 3.3 in 1990-91. In subsequent years, till 1997-98, the ratio declined and averaged 2.7%. However, the ratio showed increase thereafter and averaged 4.4% for the period 1998-99 to 2000-2001.

For the Centre and States, the combined GFD ratio was 9.4% in 1990-91. The ratio improved in subsequent years till 1997-98 (average 7.1%). However, thereafter the ratio rose to an average of 9.5% (9.9% for 2001-02).

Total Liabilities

Another way is to look at the total liabilities. For 2001-02, total liabilities of Centre worked out to 58% of GDP against 55% in 1990-91. For the States, the ratio was 26% in 2001-02 against 19% in 1990-91. For Centre and States together the ratio was 70% in 2001-02 against 62% in 1990-91.

The Fiscal Responsibility Bill 2000 envisages the ratio below 50% by March 2011.

Eleventh Finance Commission (2000) has recommended the ratio at 48% for Centre, and 55% for Centre and States together.

State of Debt Market during 1980s

In India, fiscal policy compulsions rendered internal debt management before 1991-92 passive. To keep government borrowing costs down, Treasury Bill rates were kept low, while the low coupon rates offered on government securities made real rates of return negative for several years till the mid-1980s. During the 1980s, the volume of debt expanded considerably, particularly short-term debt, due to automatic accommodation through the mechanism of ad hoc Treasury Bills. With captive investor base and interest rates below the market rate, secondary market for government bonds remained dormant. Artificial yields on government securities distorted the yield structure of financial assets in the system and led to higher lending rates and cross subsidisation. In view of the rising requirements of Government, Reserve Bank's monetary management was dominated by a regime of administered interest rates and rising CRR and SLR prescriptions. High CRR and SLR left little room for monetary maneuvering. It is against this backdrop, and in the context of the overall economic and financial sector reforms, that development of the government securities markets was initiated in the 1990s.

Reforms during 1990s

The reforms undertaken since 1990s can be briefly viewed as a systematic exercise for the development of the debt market, as well as integration of the entire financial markets by making it deep, wide and transparent. The reforms aimed at increasing the operational autonomy of the RBI, by measures such as abolition of automatic monetization of deficit through creation of ad-hoc Treasury Bills and introduction of Ways and Means Advances for the Central Government. Secondly, government borrowing was made market-rate based through the introduction of auctions in primary issues. Thirdly, improvements in institutional infrastructure were sought to be achieved through the setting up of Primary and Satellite Dealers. Fourthly, the breadth and depth of markets were sought to be improved by introduction of a variety of new instruments, viz., Zero Coupon Bonds, Capital Indexed Bonds, Floating Rate Bonds etc. Fifthly, since April 1999, the Reserve Bank has been actively pursuing the consolidation of debt through reissuance through price based auctions. This has greatly improved the market liquidity and helped the emergence of benchmark securities. It will also facilitate the introduction of STRIPS (Separate Trading for Registered Interest and Principal Securities). Sixthly, through re-issue of existing securities, the liquidity of the market improved and the process of development of benchmarks received a fillip. Seventhly, trading and settlement systems have been improved through introduction of Delivery-versus-Payment (DvP) system and operationalisation of Negotiated Dealing System (NDS) and Clearing Corporation of India Ltd. (CCIL). Eightly, a retail market in government securities is sought to be promoted through a system of non-competitive bidding at primary auctions. This is also sought to be done by encouraging banks/ PDs to provide an active secondary market for small investors. Finally, increased transparency is sought to be achieved through announcement of calendar for dated securities, implementation of standardized codes and accounting norms and dissemination of information.

Debt Management

The Reserve Bank in its role as adviser to Government is also concerned with the maturity profile of debt, timing of issuances and types of instruments, depending on the market conditions. In view of the large and growing fresh borrowings by the Government, the need to elongate the maturity profile of government debt has been felt, so as to minimize the refinancing risk.

The maximum maturity of new loan issues was reduced from 30 years in 1985-86 to 20 years in 1986-87. Thereafter, since 1992-93 the maximum maturity had been telescoped from 20 years to 10 years which continued till 1997-98. In 1998-99, the maximum maturity of loans issued was again raised to 20 years. In 2001-02, the Central Government issued a 25 year bond and in the current year a 30 year bond, successfully. The weighted average maturity of loans issued during a year rose from 5.5 years in 1996-97 to 14.3 years in 2001-02 which at present in the current year is around 12.3 years. Of the outstanding debt of Central Government, the weighted average maturity was 8.2 years as at the end of March 2002 as compared to 6.5 years at end March 1998.

In contrast to the weighted average maturity, the weighted average yield on the borrowings during the year has been declining consistently, from 13.75 per cent in 1995-96 to 12.01 per cent in 1997-98 and 9.44 per cent in 2001-02. For the period April-August, 2002, the weighted average yield works out to 7.53 per cent.

In the case of State Governments, the maximum maturity of new loan issues was reduced from 20 years in 1991-92 to 15 years in 1992-93 and further to 10 years in 1993-94. Since then, the maximum maturity for state loan has been maintained at 10 years. The weighted average yield on state loans issued during a year declined from 14.0 per cent in 1995-96 to 12.4 per cent in 1998-99 and 9.2 per cent in 2001-02. For the period April-August, 2002 the weighted average yield is 7.8 per cent.

The strategy followed by Reserve Bank revolved around timing of issues to coincide with favourable liquidity and yield environment. As a result, Reserve Bank resorts to primary acquisition of government bonds through private placement/devolvement in the case of the Central Government, when it feels that market sentiment is uncertain or when liquidity conditions are not appropriate and to meet unanticipated requirements of the Central Government, with a view to off-load in the market at appropriate times.

Since 1992, new instruments like capital indexed bonds and *floating rate* bonds have been introduced. Bonds with *call/put options* have also been introduced in July 2002. Reserve Bank is now actively pursuing the creation and development of the STRIPS (Separate Trading for Registered Interest and Principal of Securities) market. Under this method, separate tradable securities for principal and the coupon payments will be issued. All the securities will have the characteristic of a zero coupon bond. In addition to providing more flexibility in managing interest rate risk, these will also help in addressing the asset-liability mismatch problem of banks.

From the inception of the auction system, multiple price auction format (under which individual bidders have to pay according to respective prices quoted by them) has been used for auction of dated securities. With the experience of uniform price (same price for all) auctions in the issuance of 91-day Treasury Bills, the uniform price auction format has been extended to the auctions of Government of India dated securities, on a selective and experimental basis.

Recently, RBI had introduced the Non-Competitive Bidding scheme in January 2002, to encourage retail participation in primary auctions, in particular by the mid-segment investors like Urban Co-operative Banks, NBFCs, Trusts, etc., in the primary market of Government securities. The scheme provides for allocation of up to 5 per cent of the notified amount at the weighted average rate of accepted bids. Operationalisation of the Scheme for screen-

based order-driven trading on the stock exchanges to facilitate retailing is under active consideration. It is expected that the scheme will help to widen the investor base.

Technological Developments

In the recent past, important landmarks in the development of Government securities market were : operationalisation of Negotiated Dealing System and setting up of Clearing Corporation of India Ltd. The Negotiated Dealing System (NDS) (Phase I) has been operationalised on February 15, 2002. It provides on - line electronic bidding facility in primary auctions, daily LAF auctions, screen - based electronic dealing and reporting of transactions in money market instruments. It also facilitates secondary market transactions in Government securities and dissemination of information on trades with minimal time lag. In addition, the NDS enables “paperless” settlement of transactions in government securities. The system has electronic connectivity to CCIL and the Public Debt Office.

The Clearing Corporation of India Limited (CCIL) commenced its operations in clearing and settlement of transactions in Government securities (including repos) on February 15, 2002. Acting as a central counterparty, the CCIL provides guaranteed settlement and has in place risk management systems to limit settlement risk and operates a settlement guarantee fund backed by lines of credit from commercial banks. All repo transactions have to be necessarily put through the CCIL while all outright transactions up to Rs.20 crore have to be settled through CCIL.

Legal Developments

There is a proposal to replace the existing Public Debt Act, 1944, by a new Government Securities Act. All the States, except Jammu and Kashmir, have given their concurrence for the proposal and the Bill is awaiting Parliamentary approval. The new Act will simplify the procedures for transactions in Government securities, allow for nomination, lien marking/ pledging of securities, transfer of ownership in electronic form, etc.

The amended Securities Contract (Regulation) Act, 1956 (SCRA) has conferred on RBI the responsibility of regulation of government securities, money market securities which include repos in all securities including corporate debt securities since March 1, 2000.

The Fiscal Responsibility and Budget Management Bill, 2000, seeks to place limit on revenue and fiscal deficit of the Government. The Bill has been examined by the Standing Committee on Finance and is at present before the Parliament.

Market Microstructure

The system of Primary Dealers was introduced in 1995. The PDs are expected to absorb government securities in primary markets, to provide two-way quotes in the secondary market and help develop the retail market. The capital adequacy requirements of PDs take into account both credit risk and market risk. They are required to maintain a minimum capital of 15 per cent of aggregate risk weighted assets, including market risk capital (arrived at using the Value at Risk method). ALM discipline has been extended to PDs. RBI is also vested with the responsibility of on-site supervision of PDs. PDs have now been brought under the purview of the Board for Financial Supervision.

The satellite dealer system was introduced in 1996 to act as a second tier to the Primary Dealers in developing the market particularly the retail segment. The system which was in

operation for more than six years was discontinued because it did not yield the desired results.

Liquidity Management

The short term liquidity management centered around the operations of Liquidity Adjustment Facility through repo/ reverse repo transactions. The repo operations by the RBI have not only helped in managing the liquidity in the system, but also facilitated the deepening of the government securities market and providing signal to the market through the repo rate. The Liquidity Adjustment Facility (LAF) has been introduced since June 2000. Operating through daily repo and reverse repo auctions, the LAF has been assigned three broad objectives, viz., (a) to meet primarily day to day liquidity mismatches in the system and not the funding requirements of the participants, (b) restricting volatility in short-term money market rates and, (c) steering the movements in these rates consistent with monetary policy objectives. Since November 2001, fortnightly repos were introduced for developing term money market. A fixed rate repo was also introduced on March 5, 2002 to signal the market and thereby stabilizing the interest rate.

Contingent Liabilities

Reserve Bank does not manage the contingent liabilities of either the Centre or the State Governments. It, however, has been playing an active but indirect role in sensitizing State Governments to the fiscal risk inherent in the guarantees issued by them, in view of the sharp increase in such guarantees in recent years. The Technical Committee on State Government Guarantees (February 1999), constituted to examine the issue recommended, *inter alia,* on proper management of guarantees including setting a ceiling on them, setting up of a Guarantee Redemption Fund and comprehensive disclosure of guarantees in state budgets. Contingent liabilities of seventeen major States amount to Rs. 1,68,712 crore (or 8.1 per cent of GDP) as at end of March 2001 as compared with Rs. 40,159 crore (or 6.1 per cent of GDP) at the end of March 1992. The Reserve Bank also issued guidelines to all the banks advising to examine the commercial viability of projects before providing loans to State Governments/ Institutions against guarantee. The guarantee should not be treated as a substitute for commercial viability.

Consolidated Sinking Fund and Guarantee Redemption Fund

At the initiative of the Reserve Bank, Consolidated Sinking Funds (CSFs) have been set up by certain State Governments for redemption of the loans. So far 11 State Governments have set up the Consolidated Sinking Fund.

The Report of the Technical Committee on State Government Guarantees (1999) recommended that each State should set up a contingency fund or make some provision for discharging the devolvement on guarantees provided by them. The guarantee fees collected should be credited to the fund set up for the purpose. Since the recommendations of the Committee, several States have taken steps to set up Guarantee Redemption Fund (GRF) and earmarked guarantee fees received towards the Fund. So far 5 States have set up the Guarantee Redemption Fund.

Consultation Process
Cash and Debt Management

There is a Monitoring Group on Cash and Debt Management of Central Government which consist of officials of Government of India and the Reserve Bank. The group deliberates on important debt management issues.

Technical Advisory Committee

The Reserve Bank has constituted the Technical Advisory Committee (TAC) on Money and Government Securities markets to advise, on an ongoing basis, on the development of a healthy and vibrant money and Government securities markets. The Committee, which includes important market participants, academicians and policy makers, has been crystallizing the views and suggestions across various fields of the financial market and acting as a facilitator for the Reserve Bank in steering reforms in money and Government securities markets.

Conference of State Finance Secretaries

The Reserve Bank organizes conference of State Finance Secretaries twice a year to discuss the issues and problems related to cash and debt management of the State Governments. These Conferences have emerged as a useful forum for interactions between the Finance Secretaries of the States and senior officials of the Ministry of Finance, Planning Commission and the Reserve Bank of India and helped the State Government address many issues concerning their finances viz., revisions in the Ways and Means Advances, guarantees extended by States, market borrowing programme, consolidated sinking fund (CSF), transparency in fiscal operations, Guarantee Redemption Fund, interest burden on States and finances of local bodies, accounting standard and information dissemination, fiscal reforms of the States, automatic debit mechanism etc.

Transparency and Data Dissemination

To enable both institutional and retail investors to plan their investments better, an indicative calendar for issuance of dated securities during the first half of the current year has been announced.

Statistical information relating to both primary and secondary market for Government securities is disseminated at regular interval to ensure transparency of debt management operations as well as of secondary market activity. This is done through either press releases or Bank’s publications viz., (e.g., daily press release of all the transactions settled through SGL Accounts, RBI monthly Bulletin, Weekly Statistical Supplement, Handbook of Statistics on Indian Economy, Report on Currency and Finance and Annual Report)

Outlook for Future Development

Debt management in India has clearly come a long way from a passive system to a market driven exercise with developed institutions, instruments and markets. In terms of international benchmarks, India ranks on par with some of the developed countries in areas like institutional framework, risk management set-up, market development, clearing and settlement procedures and transparency in debt management operations The artificially administered interest rate system of government securities market has developed into a market determined one and an inactive thin secondary market has grown into an actively traded and reasonably liquid market. Settlement systems have developed significantly and we are moving towards a system which will be comparable with the best systems internationally.

Some of the major issues in respect of which further development is being contemplated are the following:

i) A working Group set up in 1997 had recommended separation of debt and monetary management. However, separation of the two functions would be dependent on the fulfilment of certain pre-conditions, viz., development of financial markets, reasonable control over fiscal deficit and necessary legislative changes. The feasibility and further steps for separation of government debt management from Reserve Bank is proposed to be taken up once legislative action with regard to Fiscal Responsibility Bill and amendments with regard to the Reserve Bank of India Act are accomplished.
ii) Measures to widen the base of the repo market including extending it to non-SGL account holders like CSGL account holders. Introduction of longer term repo, rollover of repos, taxation and standardised accounting are the major areas to be focussed in the near future.
iii) For the introduction of STRIPS in the government securities market, the modalities are being finalised. This can be done only after Government Securities Act is passed by Parliament. The Report of the Working Group set up in May 2002 for Suggesting Operational and Prudential Guidelines on STRIPS has been placed on the website of RBI in August 2002 for comments.
iv) The issuance calendar for Government of India securities which was introduced for the first time in April 2002 for the first six months of the year and has been successfully completed, is to be finalised for the second half of the year. It is expected to be announced soon.
v) The implementation of the next phase of the PDO-NDS project involving integration with security settlement system and primary markets operations, automation and inter-connectivity of PDOs, electronic maintenance of record of ownership, etc. is under way.

[?] Valedictory Address by Shri Mohammad Tahir, Executive Director, Reserve Bank of India, at the Seminar on Managing Public Debt organized by ASSOCHAM at New Delhi on September 3, 2002.