Managing Public Debt and Promoting Debt Markets in India*

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I welcome this opportunity to be with you and benefit from the deliberations. There is an increasing awareness of the importance of domestic-debt markets, particularly in our region. Recent events in the Asian region have brought to light the importance of avoiding excessive reliance on the banking system for financial intermediation even as the health of the banking systems is being improved. Diversification of means of intermediation and competition therein within a country adds to both efficiency and stability of the domestic financial system and avoids shift of financial intermediation outside the country. Central bankers have a special interest in fixed income markets because they are to be addressed for ensuring a transmission channel of monetary policy. In many countries government securities market is critical in view of its role in creating the risk free yield curve as a benchmark for pricing other securities. Of course, the investors and intermediaries do look for efficient, reasonably stable and transparent fixed income market, and the regulators do strive to ensure these. In brief, the current challenge before us appears to be the mechanisms by which we encourage development of debt markets, as also carefully craft appropriate roles for manager of public-debt and regulator of debt markets as a whole.

Perhaps, India has been reasonably successful in meeting this challenge so far. No doubt, the progress in equity markets has been impressive in India, as it has been in most of the Asian region. But, the recent compulsions of a larger access to market borrowings by government as a source of financing fiscal deficit, and greater opportunities for corporates to access capital markets for their debt needs in addition to Development Financial Institutions, have provided challenges and opportunities for the policy makers in managing public debt and promoting debt markets in India. The organisers suggested that we should share with you our approaches, processes and strategies for our mutual benefit.

Before narrating our experience, it is essential to recognise that country context is very very critical, and generalisations would be inadvisable. Apart from the size and structure of the economy, state of fiscal and financial sectors, pattern of corporate structures and cultures, degree of openness of the economy, the foreign currency component of public debt which is low in India, and the maturity pattern of such external obligations which is generally of longer duration in India needs to be emphasised. In brief, the domestic dimension of debt in general and public debt in particular is dominant in India's debt markets and this address today would naturally reflect such an orientation.

In fact, I was happy to read in BIS review, a speech by Governor, Chatu Mongol Sonakul on development of bond markets in Thailand, where he made a lucid presentation of the benefits of bond market, necessary conditions for development of bond markets and the criticality of a deep and liquid government bond market.

Similarly Mr. Joseph Yam, Chief Executive of the Hong Kong Monetary Authority said recently in May at Chang Mai : "there has been notably little disagreement about the desirability of developing domestic and regional bond markets. But there has also been little progress. And there has been no lack of explanation of why this is the case".

Background and Role of RBI

Recent years have seen significant transformation in the debt market in India with far reaching implications. As the process of reform continues, the role of financial markets in the economy gets significantly enhanced.

While this process essentially involves domestic liberalisation, the decision to open up the economy adds urgency and complexity to the process of developing financial markets in India. The Reserve Bank of India has been taking special efforts to develop the various segments of financial markets, in particular, money, Government securities and forex markets. Government securities market constitutes a predominant portion of debt markets in India. The relative share of non-Government bonds has also picked up in recent years, as a logical extension of reforms in the Government securities markets and opening up of the financial sector. Even so, given the size of the sovereign debt, central to the development of debt market is the development of the Government securities market.

The primary interest of the Reserve Bank of India (RBI), in financial markets is because of its criticality in acting as the transmission channel of monetary policy especially while moving towards reliance on indirect instruments of policy. Currently, the Government securities market is the overwhelming part of the overall debt market. Interest rates in this market provide benchmarks for the system as a whole. In the recent past, several initiatives have launched the market into a high growth trajectory, in terms of depth, liquidity and turnover, participants, etc. Several initiatives for development of this market have helped the success of a large borrowing programme in recent years. This is critical not only from the point of view of the Reserve Bank, which is both the debt manager and regulator, but also from the point of view of investors who are concerned about the monetary and fiscal management in the country.

The Reserve Bank's strategy takes into account the considerations of both policy makers and investors. Reform has encompassed market practices in both primary and secondary markets, strengthening the institutional structure, developing new and innovative instruments, widening the participant base, rationalising tax measures, establishing a regulatory framework, initiating changes in legal framework, and imparting transparency in operations.

Approach to Reform

The approach to reform in the Government Securities market has several features which may interest the observers. First, the reform process is characterised by the caution with a tilt towards preserving stability, by the careful sequencing, by the mutually reinforcing monetary measures and by the complementarity with other policies. Creating a conducive policy environment as will be explained later has been a priority. Further, the reform in this market has always been undertaken within the overall monetary policy framework and is coordinated with reform in money and forex markets. Second, it progressed on the basis of a clear-cut agenda, which has aided the sequencing process. Third, major reforms were implemented in phases, allowing for transition so as not to destabilise market participants. Fourth, the entire process has been facilitated through collaborative approach imparting transparency in intentions. The Reserve

Bank and Government have been working in close coordination on all issues. At a policy level, this involves legislative changes and many other parameters. At an operating level, there is a Working Group consisting of senior officials from the Reserve Bank of India and Government of India on cash and debt management, which helps the process of consultation on management of government debt. In fact, the RBI has initiated a process of periodical meetings with Finance Secretaries at State level (India is a federation of States) which has helped treasury management as well as debt management operations at State level. Fifth, a formal consultative mechanism with market participants was established by the Reserve Bank through a Technical Advisory Committee on Money and Government Securities Markets where important policy and operational changes proposed to be implemented are discussed. The Technical Advisory Committee has appointed working groups to more closely look into the technical details of policy proposals. This Committee has representation from banks (public sector, private and foreign), mutual funds, financial institutions, credit rating agencies, Primary Dealers Association and Fixed Income, Money Market and Derivatives Association (a self-regulatory organisation) and independent economists, apart from representation from Government. The Reserve Bank also holds separate consultations with Primary Dealers Association on important issues concerning public debt. Sixth, before finalising important policy changes especially on operational aspects, draft guidelines on issues are circulated as consultative papers to market participants and their comments are given serious consideration before issuing final guidelines. Seventh, coordination with Securities and Exchange Board of India, the regulator of stock exchanges and corporate debt except those with initial maturities upto one year is ensured both at a policy level and at an operational level. In particular, at a policy level, coordination is ensured through a High Level Committee on Capital Markets presided by Governor, and at an operational level through a technical group of officials, both of which include nominees of Ministry of Finance. Eighth, international best practices are constantly reviewed in inter-departmental Working Groups within the RBI before designing and opertionalising changes. Ninth, public debate is generated on the changes contemplated by announcing the intentions and proposals for structural reform through Monetary and Credit Policy statements and speeches of senior officials. Consultation and transparency are at the core of the reform process. Finally, in all these processes, the interests of investors and intermediaries are kept in view and these include a liquid market to facilitate easy entry and exit, tools for hedging, transparency in operations, an efficient settlement system, an enabling legal environment, and a clear and simple, but robust regulatory framework. Of course, development of technological infrastructure overrides all these objectives in the sense that it facilitates these objectives.

Segments of Debt Markets

There are three main segments in the debt markets in India, viz., Government Securities, Public Sector Units (PSU) bonds and corporate securities. The market for Government Securities comprises the Centre, State s and State- sponsored Securities. The PSU bonds are generally treated as surrogates of sovereign paper, sometimes due to explicit guarantee and often due to the comfort of public ownership. Some of the PSU bonds are tax free while most bonds, including government securities are not tax free. The Government Securities segment is the most dominant among these three segments. Many of the reforms in pre-1997 period were fundamental, like introduction of auction systems and PDs. The reform in the Government Securities market which began in 1992, with the Reserve Bank playing a lead role, entered into a very active phase since

April 1997, with particular emphasis on development of secondary and retail markets.

Creating a Conducive Policy Environment

Since the sixties and until the nineties, the Government Securities market remained dormant since the government was borrowing at pre-announced coupon rates from basically a captive group of investors, such as banks. In a way, we had a passive internal debt management policy. This, coupled with automatic monetisation of budget deficit prevented development of a deep and vibrant Government Securities market. As long as automatic monetisation existed, it was difficult to assure a framework for Government Securities market in terms of matching demand and supply through a price discovery mechanism. Hence, a most significant development has been the elimination of the practice of automatic monetisation of the Central Government budget deficit through *ad hoc* Treasury Bills with effect from April 1, 1997 and the introduction of a new scheme of Ways and Means Advances (WMA). In the 'nineties, several other measures were taken for creating an enabling environment for efficient market conditions. For instance, the total effective statutory preemptions of the banking system has been progressively brought down, the administrative structure of interest rates has almost been dismantled, prudential norms have been introduced gradually in line with international best practices, banking supervision has been strengthened, transparency and disclosure standards were enhanced to be on par with international standards, and risk management practices have been prescribed.

Market Development Measures

There are several ways of analysing market development, and perhaps a convenient way is to track measures in regard to instruments, institutions and participants.

Instrument Development

From the investors' point of view, a range of Treasury Bills give a variety of options for managing cash surpluses. At the same time for Government spending, long-term funds are needed to be raised in a cost-effective manner. Keeping these in view, over the reform period, a variety of Treasury Bills of 14-day, 91-day, 182-day and 364-day maturity have been introduced. In the long-term segment, the vanilla or the fixed coupon bonds are the most commonly issued instruments. However, over the years, given the large market borrowing programme of the Government and a large variety of investors, we have tried to innovate and issued zero coupon bonds, floating rate bonds, and capital indexed bonds. Government dated securities have been issued in a maturity range of 2 to 20 years depending on prevailing conditions in the market. Currently, the weighted average maturity of outstanding marketable debt is 7.75 years.

The non-Government debt market has a wider variety of bonds from very short-term to long-term maturity. These bonds have many innovative features like step-up, call and put options, and include structured obligations, etc. Much of the PSU bonds and corporate securities are privately placed.

Repos are permitted in Government Securities. It has also been decided to extend repos in PSU bonds and private corporate debt securities, provided they are held in dematerialised form in a depository and the transactions are done in recognised stock exchanges. The system is yet to be fully operationalised.

Institution Development

Early during the reform process, the Reserve Bank promoted the Discount and Finance House of India and Securities Trading Corporation of India to promote the development of the money market and secondary market for Government Securities. The Reserve Bank has subsequently sold its majority shares to market participants and these institutions have since obtained Primary Dealership in Government Securities.

Since the inception in 1995, the number of Primary Dealers (PDs) in Government Securities has progressively increased from 6 to 15. The obligations cast upon PDs include an annual minimum bidding commitment for dated securities and Treasury Bills with a minimum success ratio and commitment to underwrite the gap between the subscribed/accepted amount in respect of dated securities and the notified amount, where there is a short-fall. The PDs are allowed access to call money as well as repos/reverse repo markets and to trade in all money market instruments. They have access to Subsidiary General Ledger (SGL) and current account facility with the Reserve Bank. The Reserve Bank also conducts exclusive Open Market Operations (OMO) in T-Bills through PDs. A second level satellite dealer system exits, with the main objective of retailing Government Securities. These satellite dealers are also given some liquidity support by the Reserve Bank. A few of these SDs have graduated as PDs.

It may be of interest to some of you to note that among the Primary Dealers, the newly licensed are, J.P. Morgan, ABN Amro, Deutsche Bank, and DSP-Merrill Lynch.

The Reserve Bank has also encouraged the setting up of mutual funds dealing exclusively in gilts, called gilt funds. Like PDs and SDs, these gilt funds are also provided with liquidity support, among other facilities.

Significant reforms in the non-Government debt market should also be recognised. National and local stock exchanges have been set up with facility for trading in corporate debt, and for that matter, even Government debt, through screen based systems. The Securities and Exchange Board of India regulates the primary issuances in capital and non-Government debt markets and ensures sound trading practices through stock exchanges. Depositories have been set up to facilitate dematerialisation and quicker transfer mechanisms.

Participants

As is well known, a large participant base would result in lower cost of borrowing for the Government. In fact, retailing of Government Securities is high on the agenda of further reforms.

Banks are the major investors in the Government Securities markets. Traditionally, banks are required to maintain a part of their net demand and time liabilities in the form of liquid assets of which Government Securities have always formed the predominant share. Despite lowering the Statutory Liquidity Ratio (SLR) to the minimum of 25 per cent, banks are holding a much larger share of Government Stock as a portfolio choice. Other major investors in Government Stock are financial institutions, insurance companies, mutual funds, corporates, individuals, non-resident Indians and overseas corporate bodies. Foreign institutional investors are permitted to invest in Treasury Bills and dated Government Securities in both primary and secondary markets.

Often, the same participants are present in the non-Government debt market also, either as issuers or investors. For example, banks are issuers in the debt market for their Tier-II capital. On the other hand, they are investors in PSU bonds and corporate securities. Foreign Institutional Investors are relatively more active in non-Government debt segment as compared to the Government debt segment.

Progress in Primary and Secondary Markets

It will be useful to identify the progress in primary and secondary market. Credible systems have been established ensuring transparent mechanisms of issuance in the primary market and creating efficient mechanisms for trading and settlement in the secondary market for Government Securities.

Primary Market

Since 1992, after the market orientation of Government borrowing programme, and later after the abolition of automatic monetisation of fiscal deficit, the Reserve Bank has been resorting to primary market issues at greater frequency. Efforts are made to raise all issues directly from the market. Dated Securities are generally issued through auctions or tap sale. Primary Dealers are permitted to underwrite the entire notified amount of the auctions. Depending on prevailing market conditions, dated securities are sometimes privately placed with the RBI, and subsequently offloaded in the secondary market when conditions turn conducive. Issues have occasionally devolved on the RBI.

Until recently, Government dated securities were issued through yield based auctions. A beginning has been made during the current year with regard to consolidation of Government debt with a view to developing benchmark securities and development of a market for STRIPS. Most of the current primary issues are, therefore, reissuances of existing stock through reopening, and this has helped in consolidation of Government debt to some extent as also in creating a critical fungible mass for active trading and enhanced liquidity in the secondary market.

Treasury Bills are issued through auctions. The notified amounts with respect to T-Bills have been rationalised in the recent period. A calendar of T-Bills is announced in advance. Non-competitive bids from select participants are accepted outside the notified amount. Both discriminatory and uniform price auction methods are used, as appropriate to each of the T-Bills.

A large part of the issuance in the non-Government debt market is currently on private placement basis. Stringent entry and disclosure norms for public issues coupled with low cost of issuance, ease of structuring instruments and saving of time lag in issuance has led to the rapid growth of the private placement market in recent years. Total resource mobilisation from the private placement market has increased sharply, over 4-fold between 1995-96 and 1999-2000.

The share of private placement issues in total mobilisation from the primary capital market (public issues and private placements) thus increased from about 40 per cent in 1995-96 to around 85 per cent by 1999-2000.

Secondary Market

Banks and Primary Dealers are the major players in the secondary market for Government Securities. Most of Government Securities transactions in the secondary market are through over-the-counter (OTC) negotiated deals. However, banks are allowed to transact through brokers who are members of the National Stock Exchange and over-the-counter-Exchange of India, which facilitated screen based trading. Since 1994, the National Stock Exchange (NSE) launched the Wholesale Debt Market (WDM) segment, which provides the only formal platform for trading in a wide range of debt securities, including Government Securities. The trading system known as National Exchange for Automated Trading (NEAT) is a fully automated screen based trading system that enables members across the country to trade simultaneously. The trading system is an order driven system which matches best buy and sell orders on a price-time priority. However, in actual practice, most of the trades in Government and non-Government debt are usually concluded over-the-counter and later reported on screen. Thus, data regarding OTC deals are available on a near real time basis on the NSE screen. Similarly, the dissemination of daily data by the RBI on price and volume of Gilts traded in the secondary markets has greatly aided the price discovery process.

Currently the Reserve Bank operates the Government Securities Settlement system for those having Subsidiary General Ledger Accounts in its Public Debt offices through Delivery versus Payments System. Setting up of a Clearing Corporation for money and debt securities is in advanced stage of implementation. This will pave the way for further opening up of the repo market to PSU bonds and bonds of financial institutions held in demat form in depositories and traded in recognised stock exchanges with essential safeguards.

The aggregate volumes of trading in Government and non-Government debt in the secondary market have increased substantially over the years. However, Treasury Bills and Government dated Securities accounted for the bulk of the trading volume at over 96 per cent of the total trades. The average annual growth in secondary market transactions since 1994-95 was over 55 per cent, reflecting the increasing depth attained by secondary market in Government Securities. For instance, the average annual transactions increased over 10-fold between 1994-95 and 1999-2000.

The turnover in Government Securities (calculated by counting twice the volume of transactions in the case of outright transactions and counting four times the volume of transactions in the case of repos) during fiscal year 1999-2000 amounted to Rs.12,370 billion of which the outright turnover aggregated Rs. 9,060 billion. Thus, the average monthly turnover in Central Government securities aggregated Rs. 1,030 billion in 1999-2000 of which the average monthly turnover of outright transactions amounted to Rs.755 billion. The daily turnover has also witnessed a significant increase and is about Rs. 34 billion. Reflecting this, the turnover ratio in dated securities (defined as the ratio of total turnover to total outstanding securities) increased to 3.2 as on March 31, 2000 from 1.7 as on March 31, 1999.

Technology Aspects

Development of technology is an integral part of reforming the debt market, especially in the context of providing a technologically superior dealing and settlement system. Hence, the RBI has embarked upon the technological upgradation of debt market. The RBI has just commenced a project for complete automation of the operations of its Public Debt Office (PDO) where the settlement for all Government Securities transactions takes place. It will provide for connectivity between different PDOs, and facilitate on-line screen based execution for trade and settlement in Government Securities transactions. The project will be implemented in phases. The first phase will cover the PDO computeristion at Mumbai and facilitate screen based negotiated dealings in Government Securities and money market instruments, tendering of screen based applications in auctions, full-fledged audit trail, debt servicing, information dissemination, price list for open market operations, central information system for access by monitoring and regulatory authorities, etc. It is expected that the first phase will be operationalised well within a year. In the second phase, other regional PDOs would be linked with the central PDO system. This phase will facilitate active open market operations of the RBI through all regional PDOs. The entire project is expected to be operationalised in about a year. The Reseve Bank is also separately putting in place real time gross settlement system, which is scheduled to be operational within the same time frame.

Regulatory Aspects

In order to curb certain unhealthy trends that had developed in the securities market and to prevent undesirable speculation, the Government had prohibited forward trading in securities in June 1969 through a Notification. Recognising that rescinding the 1969 Notification is necessary for developing the debt markets, at the recommendation of the Reserve Bank, the Government recently brought about amendments to Securities Contracts (Regulation) Act 1956 which made it possible for Government to delegate some responsibilities to the RBI. Currently the regulatory jurisdiction over the Government and non-Government debt markets have been delegated to the Reserve Bank and Securities and Exchange Board of India by the Government. The Reserve Bank will regulate in relation to any contracts in Government securities, money market securities, gold related securities and in securities derived from these securities and in relation to ready forward contracts in bonds, debentures, debenture stock, securitised and other debt securities.

These amendments help the RBI to put in place, from time to time, appropriate regulatory framework, keeping in view rapid changes in financial institutions, instruments and practices governing money, Government Securities and forex markets, apart from gold-related financial products. With the delegation of powers by Government to the RBI in these matters, the procedural delays and constraints can be eliminated.

Transparency Aspects

Transparency in operations and data dissemination is the hallmark of our Government Securities market. The process of policy making and implementation of reform are through consultative mechanisms. The entire market borrowing programme is announced at the beginning of the year. Based on this, a calendar of Treasury Bills is pre-announced to the market. Similarly, near real-time data is available with regard to auctions of Treasury Bills and dated Government Securities. The Reserve Bank also publishes all relevant data pertaining to Government Securities market on daily, weekly, monthly and annual basis.

Legal Changes

The Government Securities and their management by the RBI is governed by the Public Debt Act, 1944. The procedures prescribed are archaic and some of the provisions have ceased to be of relevance in the present context. A new legislation titled the Government Securities Act proposes to repeal and replace the Public Debt Act. The Government Securities Bill has already been approved by the Cabinet and is awaiting Parliament clearance. However, since the Public Debt Act, 1944, is applicable for marketable loans raised by the RBI on behalf of both the Central and State Governments, the proposal requires consent of all State Governments. The State Governments have to pass a Resolution for the purpose either prior to enactment by the Centre or subsequently adopt the same by passing a Resolution. Once the new Act is enacted, the RBI will have substantive powers to design and introduce an instrument of transfer suited to computer environment.

Outlook

Before concluding with the outlook, I must confess that there are several areas which are important but have not been presented in this address. These include the dilemmas in the separation of debt and monetary management; aspects of risk management arising on account of issuance of long-term debt which may create asset-liability mismatches for banks, and short term debt which creates recycling problems; determining the extent of transparency without pre-empting actions of the Reserve Bank; ensuring removal of impediments on account of taxation, etc. These issues are significant and are being continuously reviewed by us.

Encouraged by the results of our efforts so far, we are now embarking on an active programme of consolidation of the reform of debt markets on all fronts, consistent with the interests of investors, intermediaries, the market borrowing programme of Government and within the broad framework of monetary policy.

The outlook for debt markets cannot be divorced from outlook for the economy as a whole. The GDP growth has averaged close to 6 per cent in ’eighties and ’nineties and the market-analysts’ consensus for this year that it would be around 7 per cent while we in the RBI place it around 6.5 to 7 per cent. Inflation has been on downtrend and moderate in the range of 4 to 6 per cent in the last five years and most analysts expect inflation in the current year to be in the range of 5 to 5.5 per cent, close to about 4.5 per cent mentioned in the RBI’s latest monetary policy. The interest rates have been generally on the down turn in the last few years, and currently prime lending rates are around 12 per cent – close to market expectations. By and large, the interest rates have been stable with general inclination towards south, till recently.

The exchange rate has been among the most stable and the exchange market continues to be characterised by non-volatile conditions by global standards.

The current account deficit is universally expected to continue to be below 2 per cent of GDP. Foreign currency reserves are high at $ 35 billion and have been rising every year in the last three years. The trend may continue this year also. The growth with stability was possible inspite of the well-known domestic and international uncertainties.

I wish to add that while taking all measures to develop the Government Securities market and ensure appropriate regulatory framework from time to time, continuous monitoring of developments on a day-to-day basis in the market is necessary to avoid excess volatility and maintain orderliness.

In all these efforts in managing policy and Government Securities market, we had unstinted support from several sources, including multinational banks and investment firms. Some of them, either directly or through joint ventures with local firms are playing a very active role in our debt markets, particularly as Primary Dealers in Government markets, duly licensed by the Reserve Bank of India. I am sure they will share their assessment of what we in the RBI intend doing. Let me advise you that exploring with them for a view on India's debt markets will be a worthwhile effort for all of you.

*** Keynote Address by Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India, at Asia Debt Conference organised by Finance Asia.com at Hong Kong on June 20, 2000.**
Dr. Reddy is grateful to Dr. A. Prasad for the assistance.