Fiscal Policy and Economic Reforms *

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I am honoured by my friend, Prof. Govinda Rao's, kind invitation to me to visit the National Institute of Public Finance and Policy (NIPFP). I had the opportunity of working very closely with the NIPFP on several occasions. Apart from my personal affinity to the NIPFP, there is a close relationship between the Reserve Bank of India and the NIPFP, from an institutional point of view also. For instance, Prof. Govinda Rao is a Member of the Southern Local Board of the Reserve Bank.

Initially, I thought of speaking on fiscal policy and economic reforms from a central banker's perspective. I realised later that while I have been working as a central banker over the last one decade, I had worked for most parts of the three decades prior to that in the Ministry of Finance, in the Government of India as well as in the Government of Andhra Pradesh. So it was a difficult choice for me as to whether I should give a fiscal view of the monetary policy or a monetary view of the fiscal policy. I have worked for a short period in the World Bank, which gives a global governments' view and also in the IMF, which gives a global monetary authority's view. As a via-media, I have opted to give a practitioner's perspective of fiscal policy, and economic reforms.

India's Fiscal Situation: A Brief Prelude

Broadly, during the first 30 years of independence, between 1950 and 1980, the fiscal deficits of both the Central and the State Governments were not excessive. This was a period of revenue

* Address by Dr. Y.V. Reddy, Governor, Reserve Bank of India at the National Institute of Public Finance and Policy (NIPFP) on May 26, 2008. (edited transcript)

This address is dedicated to Mr. S.L.N. Simha, at whose instance the transcript has been edited for publication. Mr. Simha, the *de facto* author of Volume One of the History of Reserve Bank of India (1935-1951), and a highly respected central banker takes lively interest in theory and practice of central banking even at the age of ninety. The Reserve Bank owes a lot to distinguished employees like him for its current status as a respected public institution in India.

surplus in general. However, automatic monetisation of Government deficit by the Reserve Bank which started as an exception during the mid 1950s, became a regular practice thereafter. Simultaneously, there was also a distinct shift in the management of the financial sector with the nationalisation of major commercial banks in 1969 and 1980. These two developments had a significant bearing on the relationship between the monetary authority (RBI) and the fiscal authority (Government).

There was a significant deterioration in the fiscal situation in the 1980s, accompanied by large and automatic monetisation of government deficits. The process involved issue of *ad-hoc* Treasury bills at rates initially on par with 91- day Treasury Bills. Since July 1974, the *ad-hoc* Treasury bills were offered at off-market discount rate of 4.6 per cent which was less than half of the prevailing market rates. There were two immediate consequences. One, when large government deficits were monetised, there was excess liquidity in the system, which prompted the monetary authorities to increase the cash reserve ratio (CRR) for banks at regular intervals with a view to mop up the excess liquidity. Two, to facilitate the Central Government to borrow comfortably, the monetary authority, which is also the debt manager for the Government, periodically increased the statutory liquidity ratio (SLR) to be maintained by banks. This process went on to an extent that CRR and SLR, together, pre-empted more than 50 per cent of banking sector liabilities, for a period. In other words, more than 50 per cent of the resources of the banking sector were pre-empted to primarily finance the budget deficits of the Governments. Further, the deposit and lending rates of banks were, for most part, administered. This situation impacted the health of the banking system and the consequential adjustments during the banking sector reform process were, naturally, somewhat complex.

The large fiscal deficit and its monetisation had some spill-over effect on the external sector, which reflected in the widening current account deficit in the late 1980s and early 1990s. Triggered by the balance of payments crisis in the early 1990s, when our foreign currency assets depleted rapidly to the extent that it could barely finance just two weeks of imports, we started the reform process in 1991-92. A credible macroeconomic structural and stabilisation programme encompassing trade, industry, foreign investment, exchange rate, public finance and financial sector was put in place, which created an environment that was conducive for the expansion of trade and investment. Simultaneously, several reform measures towards the marketisation of government borrowings were initiated.

At the instance of Dr. Rangarajan, one of my illustrious predecessors as Governor, the Reserve Bank entered into the first agreement with the Government in 1994 to place a limit on automatic monetisation. The First Supplemental Agreement between the Reserve Bank

and the Government of India was signed in 1994 setting out a system of limits for creation of *ad hoc* treasury bills during the three-year period ending 1996-97. Then in 1997, soon after I moved to the Reserve Bank, the second agreement with the Government was signed, where Mr. Montek Singh Ahluwalia represented the Government. In pursuance of this Second Supplemental Agreement between the Reserve Bank and the Government of India on March 6, 1997, the *ad hoc* Treasury Bills were completely phased out from April 1997, replaced by a scheme of Ways and Means Advances, subject to limits. In order to smoothen the transition, the Government of India was allowed to incur also an overdraft, but at an interest rate higher than the rate applicable for Ways and Means Advances (WMA). With effect from April 1, 1999 these overdrafts were allowed only for a maximum of ten working days. These features placed the Central Government on par with the State Governments which were brought under an 'Overdraft Regulation Scheme' since 1985. Furthermore, it was agreed that the Reserve Bank would trigger fresh floatation of Government securities whenever 75 per cent of the WMA limit was reached. It was also agreed that the Government's surplus cash balances with the Reserve Bank, beyond an agreed level, would be invested by it in Government securities. While the transition to a full-fledged WMA and overdraft mechanism was gradual, non-disruptive and consensual, the successful implementation of this mechanism made it possible to incorporate some of these practices into a law - the Fiscal Responsibility and Budget Management Act (FRBM Act). It is noteworthy that this law also practically prohibited the Reserve Bank from participating in primary issues of all Government securities.

As a result of the concerted efforts to restore fiscal balance through tax reforms, expenditure management, institutional reforms and financial sector reforms in the first half of the 1990s, there was significant reduction in the magnitude of fiscal deficit and the proportion of debt relative to GDP during the period 1991 to 1997. However, during the period 1997 to 2003, there was a reversal in the trend of fiscal consolidation, and the cumulative impact of industrial slowdown, fifth pay commission award, and a lower than expected revenue buoyancy culminated in fiscal deterioration. This deterioration in the Indian fiscal position happened at an inopportune time when there was fiscal improvement the world over and India was trying to globalise. It is important to remember that India's fiscal situation has been significantly divergent from the global fiscal situation and continues to be so even now. I think, this is the background we have to keep in view whenever we discuss the pace and the content of economic reforms in India. The coming into force of the FRBM Act, 2003 on July 5, 2004, which established a framework for a rule based fiscal consolidation, should be viewed in this background.

In the period subsequent to 2003, the Central Government's fiscal position has

been improving, though there are several underlying fiscal pressures that are not entirely evident in the numbers, as will be explained later. The States' fiscal positions have also improved significantly during this period and their revenue deficits are close to being virtually eliminated. However, as in the case of the Centre, there are some underlying pressures that are not reflected in the fiscal numbers of the States.

Despite considerable improvement in the fiscal scenario, both at the Centre and in the States, India's combined fiscal deficit (Centre and State), as a percentage of GDP, still continues to be one of the highest in the world. Prof. Rao would also be able to explain to you separately in detail that India's public debt, including the external debt, as a percentage of GDP, is one of the highest in the world. In this context, the U.K. based weekly the Economist (dated November 17, 2007 - Pages 75-77) ranked India, along with Turkey and Hungary, as the riskiest economies among select leading emerging market economies. The Economist based its conclusion on standard parameters such as current account balance, budget balance, inflation and growth in bank lending, for assessing the degree of risk. One cannot disagree with the relevance of these parameters in assessing risks. Yet it is noteworthy that most of these risky elements were present in the Indian economy for several years, almost all through the reform period, and yet the economy exhibited macro-stability and impressive growth even while withstanding some significant domestic and global shocks. In view of this evidence, we need to explore the reasons for such risks not de-stabilising our economy so far; and the measures that are needed, in future, for insulating the economy from such de-stabilising effects, to the extent feasible. I think it is important that this big picture be reckoned while we analyse the pace and intent of reforms, despite some agreement on the destination as well as direction of economic reforms.

Role of the Reserve Bank in Fiscal Reforms

Now, let me briefly explain the role of the Reserve Bank in fiscal reforms. As a central bank, we are generally sensitive to the fiscal situation. It is not true that the Reserve Bank was not aware of the implications of what was happening on the fiscal front during the first three decades (1950 to 1980). Given the institutional arrangement, the Reserve Bank's primary objective is to maintain monetary stability. It was clear that the fiscal situation was something that was decided and determined by the sovereign. Once the fiscal situation was decided and determined by the sovereign, it was the central bank's responsibility to ensure that monetary stability was maintained and the Government's borrowing programme was managed with minimum disruptions, in terms of stability. Some argue that accommodating the fiscal pressure through monetary action is like, what some people call, a soft-budget constraint.

Let me revert to the reform process and how we got rid of the remnants of automatic monetisation of the previous years. The stock of *ad hoc* Treasury bills, when we put an end to issue of such bills, was over Rs. 1,00,000 crore. This stock was in fact public debt in perpetuity, held by the Reserve Bank, bearing a discount rate of 4.6 per cent though the market rates were far higher. In coordination with the Government, it was agreed that these papers will be converted into dated marketable securities at market related rates, in phases, depending on the market conditions warranting open market operations by the Reserve Bank. Thus, the stock of the *ad hoc* treasury bills has been wiped-out. This is an evidence of the varieties of ways in which the Reserve Bank conceives and implements the process of reforms, in a non-disruptible fashion, in coordination with the Government.

Let me share a story related to the FRBM Act with you. One day, Governor Jalan said that the Finance Minister is making an announcement on introduction of Fiscal Responsibility Bill (which was the then proposed nomenclature). Governor Jalan said that he had discussed with the Minister and that they had decided that I will be named the Chairman of a Committee that would draft the Fiscal Responsibility Bill. I submitted that the Government officials should be working on the legislation relating to fiscal issues and that the Reserve Bank should not be involved, as the ownership of the Fiscal Responsibility Bill should be with the Government. Governor Jalan did not relent and said "No, it has been decided that you do it". So finally, we arrived at a compromise. A main formal Committee was set up in 2000 with the then Secretary, Economic Affairs, Dr. E.A.S. Sarma as the Chairman and Dr. Ashok Lahiri as one of the members; and a working group comprising of the Reserve Bank officials was set-up under my Chairmanship to provide technical assistance to the main Committee on several aspects for drafting the Fiscal Responsibility Bill. The Reserve Bank Working Group was actively involved in the Sarma Committee to draft the Fiscal Responsibility Bill. Mr. Prem Chand of the IMF, at our invitation, spent some time advising us on the international best practices in this regard. At this stage, we advised the Government that without incorporating transparent Budget management rules and medium term fiscal framework, the objective of fiscal responsibility would not be achieved. Therefore, the name of the Bill was changed to "Fiscal Responsibility and Budget Management Bill" incorporating additional features. In short, I am illustrating that the Reserve Bank has been actively collaborating with the Government, whenever sought, but with appropriate propriety.

Our experience shows that the FRBM Act has a positive effect of focusing attention on fiscal issues. At the same time, it may, sometimes, unintentionally lead to increased recourse to expanding off-budget fiscal liabilities. Such a practice is not entirely uncommon in many countries, but the magnitudes involved and the persistence in resorting to off-budget liabilities in India are

noteworthy. The issue is not merely one of transparency in fiscal operations or a *de facto* larger borrowing programme of the Government than admitted, but one with significant implications for the Government debt market and monetary management.

Past experience clearly suggests that recourse to such off-budget items is not *ad hoc* or one-time only. The repeated recourse to issue of Government bonds has been exercised not only for fuel, food and fertilizers for financing subsidies, but also for financing deferred liabilities in regard to bank loan waivers and contribution to the capital of public sector banks. Hence, unless there is a noticeable change in global prices or a change in policy towards recurrent subsidies and deferred liabilities, continuation of such special bonds may not be ruled out. The significant quasi-fiscal transactions to finance recurrent revenue expenditures through *de facto* borrowings pose challenges in managing the links between fiscal, external and monetary management.

The Reserve Bank has rendered advice on FRBM to the State Governments also. A forum has been provided by the Reserve Bank, which brings together the Finance Secretaries of State Governments, for exchange of ideas and sorting out the issues. The bi-annual conference of State Finance Secretaries hosted by the Reserve Bank, initiated in 1996, is also attended by the Secretaries in the Ministry of Finance, Government of India, representatives from the Planning Commission, the Comptroller and Auditor General of Accounts (CAG) and the Controller General of Accounts (CGA). The deliberations in these bi-annual conferences have proved very useful in identifying the common issues and developing best practices in regard to State Government finances. A number of important initiatives relating to ways and means advances, approach to market borrowing programme, investment of surpluses, ceilings on State Government guarantees, model scheme for state level fiscal legislations, apart from changes in the content and format for reporting budget related documents to ensure transparency, *etc.* have emanated and taken shape as a result of interactions in these meetings. The Reserve Bank has, through this forum, also helped the State Governments prepare the state level FRBM legislations.

Incidentally, the first research and policy paper on pension funds in India was prepared by Dr. Urjit Patel, who used to work with us. In those days, it was so hard to get any data that we had to tap our informal links in the various offices in Delhi, including some of my old colleagues, to give him some access to relevant information. Dr. Urjit Patel did a very good job and then he published an article in the Economic & Political Weekly. Thus, the public policy on pensions was, in a sense, triggered by the work done by a consultant in the Reserve Bank, at our request. The Reserve Bank also worked on a Report on Pensions for State Government employees. This is another evidence of the collaboration between the Reserve Bank and the Governments and often our views are

accepted. Now, let me come to the fisc and monetary management issues.

Fisc and Monetary Management

Let me clarify the general approach of the Reserve Bank in its relations with the Government on matters relating to monetary management. As illustrated in the case of preparation of the Fiscal Responsibility and Budget Management Bill, coordination between the Government and the Reserve Bank is essential for structural reforms, especially when legal and institutional changes are involved. In regard to operational issues relating to monetary policy, there is some element of freedom but, in view of the fiscal dominance in the economy, the overriding approach has been harmonisation of monetary policy with fiscal policy for ensuring stability. Within this framework, through mutual cooperation, several reform measures have been undertaken by the Government and the Reserve Bank and I will provide a few illustrations.

First, the Statutory Liquidity Ratio (SLR) has been gradually reduced to the then statutory minimum of 25 per cent, effective October 21, 1997. Also, the CRR has been reduced gradually, depending on the liquidity conditions, as a first step, with the objective of ultimately reducing it to the statutory minimum of three per cent. In the meantime, the Reserve Bank's commitment to the removal of the statutory prescriptions of minimum reserve and liquidity requirements was demonstrated by its proposal to the Government for legislative amendments to remove the minima. These legislations have since been passed. Now, there is no minimum statutory stipulation for SLR and CRR.

The challenge now is to reduce the CRR and the SLR stipulations, as we go along. The reduction in CRR will be contingent upon liquidity conditions and the need for using it as an instrument of sterilisation along with other instruments. The reduction in SLR will primarily be governed by the fiscal situation of the Government. The issue is not one of desirable destination but one of negotiating the path in an optimal way. The Reserve Bank has two options for proceeding in this regard. Either we accept the fiscal situation and wait for it to improve, to effect any further reductions in SLR or reduce prescriptions gradually consistent with fiscal situation and market development. So that is the type of choices we are facing at this juncture and the Reserve Bank prefers to assess the fiscal situation and proceed with the reductions in a cautious manner.

Second, an issue that has come to the fore in the recent period pertains to higher volatility in Government's cash balances maintained with the Reserve Bank, which impacts the liquidity conditions in the financial markets. Volatility in Government's cash balances is not unique to the Indian situation and is an issue even in other countries, but in our situation, it has become increasingly prominent now. It so happens that, at times, Government's cash balances and the external situation move in different directions and they create very little net impact on liquidity from the perspective

of overall monetary management. However, there are occasions when they move in the same direction, in which case the volatility in the liquidity conditions is much higher. This is one major current issue in monetary management which could be linked to cash management in the Government. The link becomes critical for maintaining orderly liquidity conditions in the money market and effectively using short term overnight interest rates for monetary operations.

Third, the magnitude of the combined fiscal deficit of the Centre and the States is close to half of the households' financial savings, which is the largest component of domestic savings. If fifty per cent of households' financial savings are taken away by the Government sector, it has vital implications for ensuring stability in the financial markets because the demand for funds from the non-Government productive sectors of the economy has to be met simultaneously.

Fourth, India is still a bank-dominated system and about 70 per cent of our banks (in terms of business) are owned by the Government. Thus, we could have a situation when the objective of monetary policy and the objective of broader public policy dealings with banking converge, in which case the monetary policy could be very effective. Sometimes, it could happen that the objective of monetary policy and the objective of broader public policy may not converge, in which case monetary policy may not be that effective. In other words, the effectiveness of the monetary policy depends not only on the actions of the monetary authority, but also on other public policy postures. This certainly complicates monetary management. Of course, the issue of conflict of interest in public sector banking and Government ownership is yet another issue. The issue of conflict of interest in private sector banks arises when the owner of the bank borrows from his own bank. The single largest source of borrowing for the Government being the Government-owned banks themselves, this conflict is rather apparent.

Fifth, one of the factors imparting rigidity to the interest rate structure in India is the administered interest rates, particularly on small savings instruments. In this context, administered interest rates fixed by the Government on a number of small saving schemes and provident funds are of special relevance as they have generally offered a rate different from those on corresponding instruments available in the market, in some cases along with tax incentives. The administered interest rates significantly impact the level and allocation of savings. On the lending side also, there are some administrative prescriptions for banks. Depending on how it is calculated, on both the savings and the lending sides, the administered structure of interest rate would apply to about 25 to 40 per cent. In this context, it is pertinent to note that the monetary policy mainly operates through interest rates and interest rate signals, and constraints posed by administered

interest rates have to be duly recognised while dealing with issues relating to monetary policy transmission mechanisms.

Sixth, theoretically it is well recognised that monetary policy is generally a more effective counter-cyclical policy instrument than fiscal policy because interest rate changes can be made and reversed quickly. However, monetary policy adjustments may take longer than fiscal policy adjustments to affect aggregate demand. It is also recognised that fiscal policy contributes to broader-based stabilisation through the impact of taxes and Government spending on income-sensitive (in addition to interest-sensitive) components of aggregate demand. When monetary policy is thus constrained in responding to output variations, fiscal policy should normally take a more central role. Thus, effective co-ordination between the fiscal policy and monetary policy is important. At a more aggregate level, in the context of our capacity to respond to global developments, if we have a counter-cyclical policy approach, not only the monetary policy but also the fiscal policy should be counter-cyclical. If the fiscal policy continues to be uni-directional, as we have in our case, with persisting deficits, then the fiscal policy is not in a position to produce a reasonable counter-cyclical impact. In these circumstances, the monetary policy has a challenge in designing and implementing appropriate counter-cyclical policies, that has the added burden of off-setting the impact of the fiscal policy. Well, despite these challenges, the Reserve Bank has managed the situation reasonably well and we have the confidence that we would be able to continue to manage. However, it is important to recognise that, at times, unorthodox policies have assured the stability of the Indian financial system despite fiscal stress, which is a desirable outcome rather than achieving ritualistic compliance with pre-set rules.

By and large, these are some illustrations of the links that exist between fiscal and monetary management. We are continuously refining the monetary policy framework and the conduct of the monetary policy, taking into account the progress in fiscal consolidation. The reform of the monetary policy framework and the conduct of monetary policy have to recognise the fiscal, and the related institutional as well as policy constraints. That is the limited point I want to make to those who are impatient with the current monetary management framework.

Now let me go to fisc and the financial market.

Fisc and Financial Markets

First, the foremost link between the fisc and financial markets is through the Government securities market. As has already been explained in detail, the Central Government's borrowing programme was significantly monetised in earlier days. It may be of interest to all of you to know that since a large part of the borrowing programme has to be completed in the first half of the fiscal

year, in view of seasonality of demand for credit on private account, the monthly average gross market borrowings by the Centre is around three-quarters of a per cent of GDP in recent years. Despite this high level of Government borrowing programme, the Reserve Bank, as debt manager, has been able to successfully complete the market borrowing programme, over the years, while pursuing its interest rate objectives without jeopardising external balance, by taking recourse to several initiatives in terms of institution, instruments, incentives and strategies.

Second, an important issue that remains is that we cannot claim that there is a genuine market for Government securities in India, when we have a statutory liquidity ratio prescription of 25 per cent. The question is that can we really proceed on the assumption that there is a genuine Government securities market, and hence reinforce more marketisation by rapidly reducing SLR or do we ensure a viable market borrowing programme and reduce SLR in tandem? Here again the Reserve Bank has to assess the sensitivity of the fisc to interest rate burden, in case SLR is reduced rapidly? The importance of SLR status for bonds issued by Government has come to the fore recently when oil bonds issued by Government of India turned out to be illiquid despite carrying a higher yield of 25 basis points over SLR-eligible bonds of similar maturity. The reform of debt markets in India, as we go along, should recognise these realities.

Third, in the case of State Governments, when we tried to marketise the individual State's borrowing programme, many of the States were not comfortable. They were not sure whether they would be able to get subscriptions for their bonds unless the Reserve Bank manages the borrowing programme of all the States in a coordinated fashion with uniform terms and conditions for all States. Knowing that banks cannot be compelled to subscribe to the programme, the Reserve Bank provides the investors a a higher yield for States' paper over the Centre's paper of comparable maturity. Subsequently, we encouraged some States to go through auction route on a stand-alone basis. Now it has become possible for the Reserve Bank to conduct the borrowing programme of each State without serious disruption in the markets, through the auction route. As a result, some States have also begun to take initiatives to improve their fiscal profile and discharge their liabilities promptly to banks, and, consequently, gain comparatively favourable treatment in the debt market. It took about six to seven years for the Reserve Bank to equip the State Governments and the markets to get used to this kind of discipline. This was perhaps possible because the Reserve Bank commands the trust of State Governments as an apolitical and a professional public institution.

Fourth, another aspect worth exploring is the fiscal implications of failure of financial institutions and markets. The Reserve Bank, as the central bank of the country, is also responsible for ensuring financial stability. Broadly, one can say that when a country's fiscal

position is strong, its capacity to take on the risks arising from the failure of financial institutions is higher. On the other hand, with a weak fiscal situation, the capacity to take care of a financial or banking crisis is rather limited. More important, whenever pockets of vulnerability arise in the financial sector, the headroom available in the fiscal position to provide succour to financial entities needs to be assessed. In this context, one important source of strength as well as vulnerability remains the publicly owned financial institutions, which may have fiscal implications. They contribute heavily as a source of tax revenue. Another source of linkage is the cross subsidies and we have to identify the areas of maximum cross subsidies in public sector entities. The sources of indirect subsidies through and by financial intermediaries are also important. A reading of the several Budget speeches of the Finance Ministers in recent years would show the extent to which activities of public sector financial intermediaries operate as instruments of fiscal policy though these entities are competing in the market with private sector on all fronts. These public policy oriented operations of the public enterprises at the instance of fisc seriously limit the efficient price discovery, depth and vibrancy in different segments of the financial markets. Thus, it is evident that while analysing the link between the fiscal and the public sector, perhaps, one should not confine to public sector borrowing requirements only.

Fifth, as regards further reforms in the financial markets, it is very clear that the development of insurance and pension sectors are very important especially for the Government debt market and the corporate debt market. However, there are some challenges in this regard. The tax treatment of investment in debt and equity is quite asymmetrical in India with a favourable tilt towards investment in equity. There are limited incentives for encouraging contractual savings. Hence, some of the areas that have to be looked at, as we move forward, relate not only to the demand side which advocates development of financial markets, but also to the supply side through policies that promote contractual savings, especially through pension and life insurance funds.

Now let me move to the fisc and the external sector.

Fisc and the External Sector

In the context of the external sector, there are certain issues from the perspective of fiscal policy that are of contextual relevance.

The first issue pertains to the opening-up of Government debt market to non-residents through, what we may call foreign currency sovereign debt. In fact, about a decade ago, several arguments were put forward in favour of issuing foreign currency sovereign debt when the Government's intention to take recourse to sovereign borrowings in the international markets was formally announced by the Hon'ble Finance Minister. Several academics argued in

favour of the proposal since they felt that it may be more economical for the Government to raise funds abroad. However, such borrowings may entail foreign currency exposure and hence the foreign currency risk, which was not built into the analysis of benefits. Another line of argument that was put forward in favour of foreign currency sovereign borrowings was that the Government's borrowing abroad would help develop a benchmark for the private sector foreign currency debt. However, now weightage for sovereign risk is assigned to a private sector debt even without the sovereign benchmark, after taking into account the sovereign risks. Moreover, the issue is that there are always political and economic temptations, as happened in many other countries, to raise foreign currency sovereign debt, when credit market sentiment is favourable probably without factoring-in the likely situation that may prevail when the sentiment turns unfavourable.

The Reserve Bank worked along with the Government when this issue came up and came to the conclusion that, at that point of time, it might not have been desirable to issue foreign currency sovereign bonds. One of the arguments against approaching the international markets for sovereign bonds was the persistence of a large revenue deficit of the Government. Thus, in the above context, the point to be considered is that, given the magnitude of the public debt as a percentage of GDP and the magnitude of fiscal deficit, whether public policy would have the same manoeuvrability for maintaining stability if the debt is denominated in foreign currency and held by the non-residents.

In the above backdrop, it may be concluded that, given the fiscal situation, the health of financial institutions, and the stage of development of financial markets, the scope for non-resident participation in the Government securities market particularly foreign currency denominated bonds may be expanded only gradually. However, the pace of opening up of foreign currency sovereign debt for non-residents would be dependent upon the pace of progress on the fiscal, institutional, and market fronts.

Second, another key issue basically from the practitioner's perspective is the fiscal cost of market stabilisation scheme (MSS). Perhaps I should explain the background and story, since this is an academic forum. Around the end of 2003, when I joined as Governor, we looked at the macroeconomic parameters and we anticipated large capital inflows. During the late 2003 to early January 2004, two Groups were constituted in the Reserve Bank, one was on the issue of sterilisation and the other was for review of liquidity adjustment facility (LAF) which was in operation since 2001 as part of the monetary policy operating framework. The draft reports of these two Technical Groups and their deliberations were placed in the public domain on the Reserve Bank website and were intensely debated. Anticipating enhanced capital inflows in future and the possible volatility in liquidity, while MSS was introduced as a new instrument of

sterilisation, the focus of LAF was shifted by the Reserve Bank to management of the day to day liquidity fluctuations.

The related issues that surfaced were that if there is accumulation of foreign exchange due to market interventions, whether to sterilise or not to sterilise and finally if we decide to sterilise, how much to sterilise and who should bear the sterilisation cost. One view was that, similar to the practice in some other countries, the central banks may take decisions not only on intervention but also on sterilisation and accordingly the central bank may issue its own bonds. As a prudential requirement, the Reserve Bank is prohibited from such bond issuances. As a result, the MSS was introduced whereby sterilisation was through issuance of Government securities.

Simultaneously, given the larger public policy implications of the exchange rate in the Indian context, it was deliberated whether it was desirable for the central bank alone to take a view on the extent of sterilisation. After considerable debate between and within the Government and the Reserve Bank, it was agreed in march 2004, that the limit MSS would be prescribed by the Government from time to time in the light of proposals from the Reserve Bank. This implies that by prescribing the limits for the MSS, the Government was recognising the fiscal cost that it was ready to bear in the context of external sector management.

Third, the related issue was whether the fiscal cost of sterilisation should be borne by the central bank or by the Government. We were unique in showing it as a part of the Government's Budget unlike the practice followed in some other countries. It would be pertinent to mention that the practice of taking quasi fiscal cost on the central bank balance sheet has led to erosion of capital base of many central banks. Although these central banks operate autonomously, the consequences were erosion of capital and subsequent recourse to the Government for infusion of capital. Thus, in the Indian context, the major fiscal cost attributable to sterilisation in the context of external sector management is clearly shown in the Government's Budget, through the mechanism of MSS, which adds to fiscal transparency. Incidentally, the desirability of MSS was discussed afresh with the Government after June 2004, when a new Cabinet was sworn in and they reconfirmed the MSS arrangement as a desirable one.

Fourth, contextually, there have been some studies by the IMF and the ICRIER on the quasi fiscal cost of sterilisation in India. Technically, it is possible to look at total accounting returns. However, to assume that whenever central bank accumulates reserves it has an adverse impact on the balance sheet, may, however, not turn out to be universally right. For instance, till the last year, China's domestic interest rates were lower than the return on foreign currency assets. In that case, the carrying cost of reserves was negative for the Chinese

central bank, resulting in a quasi fiscal benefit.

Fifth, a related issue in this regard is valuation of forex reserves on a marked-to-market basis on the balance sheet of the Reserve Bank. An appreciation of the reserve currency translates into losses. But in some senses one can argue that such loss is notional. Again, every central bank has different ways of accounting. Most of the central banks and, definitely, the Reserve Bank, adopt a conservative accounting practice so that unrealised gains are not shown. The issue here is how one calculates the cost of holding reserves or even "excess" reserves. Since this is essentially an opportunity cost, the only way that it can be calculated reasonably is in terms of interest rates on local currency assets *vis-à-vis* those for foreign currency assets. But interestingly, the question that arises is how to account for the macroeconomic benefits. Many central banks, with or without the concurrence of the Government, are adding to the reserves or are holding on to the reserves even though they incur a quasi fiscal cost. This clearly suggests that there must be some benefits of such a widely adopted practice and if so, what are these benefits? My submission is that these benefits unfortunately are not quantifiable. But just because they are not quantifiable, I do not think it is appropriate to ignore them. The list of benefits can be summarised as follows. One, it enhances the confidence in the economy, particularly of the emerging market economies and results in a better sovereign rating. This, in turn, translates into finer spreads at which both public and private sector can raise money. Two, it enhances the capacity to absorb shocks. The shocks can be of two types: the real sector shocks in terms of oil shocks, food grain shock or both of them and the financial shocks in terms of the financial flows. On both, the real sector and the financial sector, there is scope for smoothening volatility when there are adequate reserves. Apart from these, one arguably fundamental issue is whether some excess volatility can be moderated in order to avoid the destabilising effects on growth and employment. Therefore, we have to recognise not only the costs - the cost of holding reserves may be negative or positive - which are quantifiable but also the benefits which are not quantifiable. These have public policy implications as there is a fiscal policy element, namely the quasi-fiscal cost of reserves.

Sixth, there is another link between fiscal policy and reserves. If one reads the rating agencies' sovereign rating, one may find a mention of how forex reserves are perceived to provide a cushion against fiscal conditions. In some sense, therefore, even if there is a fiscal cost of carrying reserves, they also give a benefit to the fisc and this is recognised by analysts. Maintaining orderly conditions in forex markets can be viewed, in some senses, as a public good and if the provision of such a public good to market participants involved addition to or depletion of forex reserves, incurring of the attendant fiscal costs, if any, of holding reserves may be justifiable.

Let me now come to the concluding section on the Reserve Bank's approach to fiscal policy.

Reserve Bank's Perspectives on Fiscal Policy

The Reserve Bank's approach to fiscal reforms is that while we agree on the need to eliminate the revenue deficit, and agree on a nominal limit for fiscal deficit, what is even more important is the mode of financing the fiscal deficit and the use that the resources so raised are put to. In addition, we focus on fiscal empowerment which was clearly articulated around 2000 in the Annual Report of the Board of Directors of the Reserve Bank. Exclusive focus on fiscal deficit may tend to reduce the role of the Government, and consequently, it will not be in a position to aid the process of growth, in particular, inclusive growth. Re-prioritisation of expenditure may be achieved through reduction or elimination of subsidies and deployment of resources thus released to the more needy sectors. Higher level of resources may also be available through reduction in tax exemption.

So the whole idea is that, in an economy like ours which requires structural transformation and investment in social and financial infrastructure, we should strive for an appropriate level of fiscal activity particularly because public goods have to be provided and that would enable us to maintain fiscal discipline and macro-stability rather than aim for a mechanical reduction in fiscal and revenue deficits at a lower level of fiscal activity.

In the light of financial turbulence across the world in the recent period, the relevance of the fisc in the management of the macro economy has become even more important. When we have not seen such financial turbulence in our country, it is important to remember that when all else fails, it is only the fiscal that has to take the hit and come to the rescue.

I would like to read out a sentence from one of the rating agencies and then make my comment, to conclude. It says, "India's monetary management is conservative and prudent, together with its low external debt position and relative ease in local currency funding, this helps alleviate its fiscal weakness." The important point here is if the Reserve Bank's policy is helping to alleviate fiscal weakness, how can it be conservative? It perhaps needs to be described as 'appropriate'.