Bond Financing and Debt Stability:
Theoretical Issues and Empirical Analysis for India

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The Development Research Group (DRG) in the Reserve Bank of India has brought out a study entitled "**Bond Financing and Debt Stability: Theoretical Issues and Empirical Analysis for India",** the nineteenth in the DRG Study Series. The Study is authored by Prof. Vivek Moorthy, Shri Bhupal Singh and Dr. Sarat Chandra Dhal.

The DRG Studies series have an accent on policy-oriented research. They are released for wide circulation with a view to generating constructive discussion among professional economists and policy makers on subjects of current interest (the study is available on RBI website http://www.rbi.org.in). The views expressed in these studies are those of the authors and do not reflect the views of the Reserve Bank.

The study examines the theoretical considerations and empirical results of the switch to market borrowing, *i.e.* bond financing of the fiscal deficit, with correspondingly low monetisation, as part of India's structural reforms initiated in 1991. It basically concludes that despite the sharp deterioration in State finances and persistently large market borrowing programme of the Centre, the move to market borrowings to finance the deficit is proving to be beneficial when viewed in relation to broader movements in the major fiscal variables over time. The study makes a clear distinction between the consequences of borrowing at market interest rates versus those of non-market liabilities.

In preference to recent econometric approaches to test the Government's long run debt profile, the study proposes a simple necessary condition, popularly known as the Domar condition, to evaluate the prospects for debt stability under which GDP growth should exceed the interest rate on Government debt. Based on the premises that in the long run, it is not possible to trade growth for inflation (although such a trade off may be possible in the short run) and that the central bank is unable to influence real variables (real output and real interest rates) in the long run, the study simulates different short and long run consequences of alternative combinations of bond and money financing of budget deficits on interest rates, growth, inflation, the debt-to-GDP ratio and measures of the interest burden.

Empirical evaluation of the Domar debt-stability condition reveals that Central Government debt, under certain assumptions, may remain stable at prevailing levels of the primary deficit and monetised deficit. High administered rates in the Small Savings and Provident Fund Schemes, i.e., **due to non-market based borrowing,** however, pose problems for debt sustainability in future. The study argues that bond financing of the fiscal deficit has contributed to fiscal consolidation by **inducing** the Government to reduce **primary** expenditures**.** This conclusion holds even for the combined finances of the Central and State Governments. Robust evidence indicates that **non-government borrowing costs have come down** relative to those of the Government, and credit conditions for non-government borrowers are **now easier**, after the move to bond finance. Further, some evidence suggests that private capital formation has surged in recent years, contradicting the view that the anti-inflation policy of bond finance has crowded out private investment and adversely affected growth. However, the stability in market debt notwithstanding, the **overall** fiscal situation is critical because of potential instability in non-market debt and due to unfunded and contingent liabilities of the Central and State Governments.

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