7

Public Debt Management

Introduction

The Reserve Bank manages the debt of the central and state governments and acts as a banker to them under the provisions of the Reserve Bank of India (RBI) Act, 1934. While these functions are obligatory in the case of the central government, the Bank undertakes similar functions for state governments by agreement with the governments of the respective states. All states have such agreements.[1]

During the years covered in the book, major institutional reforms were undertaken that redefined the relationship between the Government of India and the Reserve Bank, facilitated market borrowing, introduced new instruments and participants in the government securities market, and contributed to a significant improvement in the state governments' fiscal and debt management. Many of these changes followed the Fiscal Responsibility and Budget Management Act, 2003 (FRBM Act), and similar legislation passed at the level of the states.

The chapter describes this transition. It covers four main topics, which are the system of public debt management, operation of the system in respect of the central government and state governments during the reference period and miscellaneous issues not covered elsewhere.

The System of Public Debt Management

Objectives

As the manager of public debt, the Bank's overall objective was to ensure smooth completion of the annual market borrowing programmes (MBPs) of the central and state governments. The Bank tried to pursue debt management in such a manner that the design of the programme was consistent with monetary policy and financial development goals. While performing this role, the Bank tried to achieve three broad aims: minimise cost, mitigate risk and develop the government securities market. During the reference period, cost minimisation was sought to be achieved by proper demand estimation and planned issuance and offering of appropriate debt instruments.

The sovereign debt portfolio is exposed to rollover risk (risk associated with old debt maturing and rolling over into new debt), currency and exchange risks and sudden-stop risks (abrupt cessation of capital flow). Even though raising debt in foreign currency might at times be cost-effective, and provide a wide and varied investor base, such dependence could mean exposure to sharp volatility in the exchange rate. Given these considerations, no sovereign foreign currency bonds were issued by India. Investment limits for foreign institutional investors in government securities were enhanced in a phased manner. The limits were apportioned to different categories of investors, with a preference for long-term investors and investments in longer maturities.

Strategy

The debt management strategy during the period of study concentrated mainly on diversification of investor base, managing maturity profile of marketable debt, the timing of issuance, consolidation of debt stock and managing the composition of different instruments.

Steps to diversify the investor base could potentially mitigate risks by reducing 'herd mentality'. In the government securities market, banks were initially the main investors in the short- to medium-term securities, and insurance companies and provident funds the main investors in long-term securities. Over time, cooperative banks, regional rural banks (RRBs), pension funds, mutual funds and non-banking financial companies (NBFCs) also entered the market. During the period of the study, the Reserve Bank took several steps to promote retail participation.

Longer maturity of the portfolio can potentially limit rollover risk. Securities with short maturities also put pressure on government finances due to bunched repayments and refinance risk (the possibility of reissues not being fully subscribed). These risks can be mitigated by limiting issuances in short-term bonds and increasing issuance of medium-term and long-term bonds, subject to investor preferences, and the shape of the yield curve. This broad aim was achieved by reducing issuance of one–five-year maturity bonds, moderating issuance in five–nine years and increasing the share of the ten–fourteen-year tenor. Bonds in tenors of more than fifteen years were increasingly issued to meet the needs of insurance companies and provident funds. Banks responded to this move robustly. The weighted average maturity (of new loans) increased from 6.6 years in 1997–98 to 14.3 years by 2001–02 and stabilised around that level thereafter.

Considering the trade-off between the carrying cost and uncertainties in market timing, the Reserve Bank's strategy involved making the timing of issues coincide with favourable liquidity and yield environment. To meet any unanticipated needs of the government or when the market sentiment was rather uncertain or when liquidity conditions were unfavourable, the Bank resorted to primary acquisition of government bonds through private placement or devolvement. This practice continued until the FRBM Act became operational from April 2006.

Consolidation of debt stock could help in the emergence of benchmark securities in the market, and thus aid the price discovery process. During the reference period, active consolidation was not resorted to in view of administrative cost and legal considerations, but because of continued issuance of bonds in benchmark securities, a passive consolidation did take place.[2] The Bank attempted to issue a variety of instruments of varying maturities to cater to the preferences of different investors, besides fixed dated securities. For example, some investors (banks and financial institutions) might like to invest in floating rate bonds for their duration management. Similarly, institutional investors, such as insurance companies, provident funds and pension funds, would prefer to buy long-term bonds, zero coupon bonds and inflation-indexed bonds for liability management. During the reference period, inflation-indexed bonds and bonds with call and put options were issued.

Several other steps to develop the government securities market, including changes in the mode of settlement, strengthening of primary dealer mechanism and creation of new instruments, have been discussed in the chapter on financial markets.

The Institutional and Legal Framework

To keep pace with the developments taking place in the financial markets and provide an investor-friendly legal framework, the Reserve Bank drafted a new law, the Government Securities Act, 2006, which was enacted in August 2006. This Act replaced the Public Debt Act, 1944, and the now repealed Indian Securities Act, 1920. The Government Securities Regulations, 2007,

Table 7.1 Debt Management Functions of the Reserve Bank of India

Primary			
Policy	*Planning*	*Debt service*	*Coordination*
Set debt management objectives, design annual debt management programme, a mix of debt instruments and devise the structure of stock of debt. All these are done in consultation with the Ministry of Finance.	Estimate borrowing requirement in consultation with the Ministry of Finance	Payment of interest and redemption	Coordinating public debt and monetary management
Operational			
Primary issues	*Secondary market*	*Marketing*	*Financial market*
Issue dated securities and treasury bills	Manage outstanding debt	Organise sale of securities	Develop financial markets
Advisory and research			
Advise government on cash and debt management, research practices and developments in the field, and disseminate information on new practices to achieve transparency and efficiency.			

were framed by the Bank in accordance with the Act, which came into force from 1 December 2007. The new Act and the regulations allowed for automatic redemption facility, the facility of pledge or hypothecation or lien on government security, simplified procedures and documentation, and nomination facility of securities. The Act empowered the Bank to call for information, cause inspection, issue directions in relation to government securities and impose a penalty in case of contravention of the Act.

Public debt management involved several institutions, which are described in Tables 7.1 and 7.2. The Bank's responsibilities may be classified under three categories. First, as an adviser, the Bank keeps the Ministry of Finance informed of the conditions in the financial system, especially the liquidity conditions in the banking sector and timing of issuance of government securities, so that the fiscal deficit is financed and monetary policy objectives are served. Second, as the issuing agency and redemption agent, the Bank devises procedures for issue and delivery of securities, collection of payments and redemption of securities. Third, as the fiscal agent, the central bank makes payment to and receives payment from investors. Further, as the

Table 7.2 Institutions Responsible for Internal Public Debt Management (as of March 2008)

	Central Government Debt	
Ministry of Finance	*Reserve Bank of India*	*Controller General of Accounts*
Sets borrowing programme in consultation with the Reserve Bank. Decisions on instruments, method and calendar of issuance of securities.	As the regulator of markets, manages primary market functions, such as auction procedures, and the functioning of financial markets, including the government securities market. Also attends to depository and servicing functions, clearing and settlement systems, technological innovations, and regulatory and supervisory matters.	Maintains accounts of public debt.
	State Government Debt	
State government	*Reserve Bank of India*	*Controller General of Accounts*
Debt of state governments is a state subject.	The Reserve Bank manages the debt of state governments in accordance with the agreements entered into with the respective states.	The debt accounts are maintained by the Controller General of Accounts of the state concerned.
State legislatures have exclusive power to make laws relating to the debt of the state concerned.	The quantum of annual borrowing was (during the period of study) decided upon in advance in consultation with the Planning Commission and the Ministry of Finance, Government of India.	

banker to the government, the Bank holds government deposits. In the light of its monetary policy role, the Bank has been made responsible for secondary market functions.

Coordination between the Government and the Reserve Bank

One of the most important parts of the process of debt management is the coordination between the Bank and the Ministry of Finance. There were changes in the framework of coordination since the late 1990s. Following the Supplemental Agreement with the Government of India, the issuance of ad hoc Treasury Bills (T-bills), which led to automatic monetisation of the fiscal deficit, was discontinued from 1 April 1997.[3] At the same time, a system of ways and means advances (WMA) was instituted. The term refers to the temporary accommodation granted by the Bank to the central government to meet mismatches in its receipts and payments. As ad hoc T-bills were phased out, and reliance on high-cost sources of funds like small savings reduced, market borrowings increased.

With the increase in market borrowing, the major risk associated with the management of public debt was the size of the debt itself. It exerted pressure on the capacity of the market and on yields (Appendix 7A.1). Since the early 2000s, the Bank adopted various measures to deal with this situation, including market-related primary issuance of government securities, the introduction of instruments and alignment of maturity periods of new issues of debt, while keeping in view the redemption pattern of the existing stock.

In view of these challenges, the Bank and the government recognised the need for greater coordination. The coordination was to be achieved mainly by four means. First, the Monitoring Group on Cash and Debt Management, consisting of the officials of the Ministry of Finance and the Bank, met periodically (usually twice a year) to assess the fiscal situation and the implications for borrowing requirements. Second, the Financial Markets Committee (FMC-RBI) operating within the Bank met daily, or, if necessary, more frequently, to share information on the government's liquidity needs and market conditions. Third, debt management officials participated in the monthly monetary policy strategy meetings. Fourth, the Bank was involved in the annual pre-Budget exercise of the government which sought to achieve consistency between monetary and fiscal programmes. The FRBM Act was a landmark step in creating an operational rule for fiscal policy and defining the roles and responsibilities of the central government and the Bank in public debt management.

The Making of the FRBM Act

Responsible fiscal policy had become an urgent matter in the 1990s. The Bank through its annual reports, speeches of Governors in various forums and in correspondence with the government repeatedly stressed this point and mooted the idea of a fiscal responsibility legislation.[4] The Bank had also been trying to advocate prudence in extending sovereign guarantees, which resulted in some states passing legal enactments and the Government of India creating a guarantee fund. State Finance Secretaries were working as a committee assisted by the Bank on issues relating to the Budget process and transparency.[5]

The first intimation of a proposal for a Fiscal Responsibility Bill (as it was named then) came from the Ministry of Finance on 1 December 1999. Initially, the Finance Minister decided to ask then Deputy Governor Y. V. Reddy to head a committee to be set up to draft this legislation.[6] However, Reddy's reluctance to head a fiscal legislation led to a compromise. A committee was set up under the Economic Affairs Secretary, E. A. S. Sarma.[7] Within the Bank, an internal working group under then Deputy Governor Reddy's chairmanship was created to provide technical assistance to the committee.[8]

The Bank's assignment was completed in about six months. The team produced an approach paper and a preliminary draft of the Bill. In the draft Bill proposed by the Bank, the objective of the legislation was 'to promote a rule-based fiscal behaviour within the government with a view to restoring fiscal discipline'. In the draft that was finally adopted, the wording changed. The Bill was expected 'to provide for the responsibility of the Central Government to ensure inter-generational equity in fiscal management and macro-economic stability by progressive elimination of revenue deficit, removal of fiscal impediments in the effective conduct of monetary policy and prudential debt management....' Both versions retained an accent on transparency.

Subsequently, certain other suggestions of the Reserve Bank's working group were not incorporated by the government in the draft Bill, for instance, (*a*) provision for an independent section stating that the Act would be binding on the central government, (*b*) a clause stating, among other things, that 'every fiscal policy statement shall be accompanied by the statement of responsibility, signed by the Finance Minister of the Government' and (*c*) a clause proposed by Governor Jalan relating to the deficit of public sector undertakings (PSUs).

Passage of the FRBM Bill

The FRBM Bill, 2000, was introduced in the Lok Sabha in December 2000. The Parliamentary Standing Committee on Finance was of the view that, while planned deficit financing was a good idea, the numerical ceilings and the time frame set for attaining the levels induced excessive rigidity into decision-making. Therefore, the committee recommended that the numerical targets should be incorporated in the rules to be framed under the Act, rather than in the Act itself.

The Bill became law in May 2003. In accordance with the new Act, the government framed the FRBM Rules, 2004, which became effective from 5 July 2004. The rules set targets for phased reduction in key deficit indicators over the period ending 31 March 2008. The rules also imposed annual ceilings on government guarantees and additional liabilities.[9] Although both the Bank and the government, in their assessments of the operation of the FRBM Act, congratulated themselves on the steps taken, economists and media experts expressed misgivings, especially on the 'dilution' of the original draft. In an interview to *Business Standard* (28 February 2008), Economic Affairs Secretary Sarma commented that the Act, though a big step forward, was a weaker version than the draft recommended by the committee. The point was reiterated in a stronger language in the *Indian Express* (22 December 2003) and by Saumitra Chaudhuri of the Investment Information and Credit Rating Agency of India Limited,[10] as reported in the *Financial Express* (3 November 2002). C. P. Chandrasekhar and Jayati Ghosh in *Business Line* (7 July 2004) considered that by ruling out loans from the Reserve Bank, the Act also ruled out a cheap source of borrowing, and forced the government to borrow at higher rates 'for no evident reason'. They were uneasy about the stipulation that when there was a shortfall in revenue, the government might cut expenditures even if the expenditure was necessary.

One specific point of criticism related to the enforcement provisions. If a target was missed, the law required the government to report to Parliament, outlining the reasons for the overrun. The fiscal rule in the FRBM Act was narrow, in that it kept public sector enterprises, state governments and their enterprises outside its ambit.[11] However, others felt that the FRBM Act did adopt rather more exacting transparency requirements.[12] It required the executive to submit to Parliament additional documentation in support of the Budget.

The main features of the Act and the Rules are shown in Box 7.1.

Box 7.1 Main Features of the FRBM Act, 2003, and the FRBM Rules, 2004

The Act

- The central government to take steps to reduce the fiscal deficit to eliminate revenue deficit by 31 March 2008 and thereafter build up adequate revenue surplus.
- Rules made under the Act would specify annual targets for the reduction of fiscal deficit and revenue deficit, contingent liabilities and total liabilities.
- The deficit may exceed targets on exceptional grounds such as national security or national calamity.
- The central government shall not borrow from the Reserve Bank except by way of advances to meet temporary excess of cash disbursements over cash receipts.
- The Bank would not subscribe to the primary issues of central government securities from 2006–07.
- The central government to take steps to increase transparency of fiscal operations.
- The central government to submit in each financial year before Parliament a Medium-Term Fiscal Policy Statement, a Fiscal Policy Strategy Statement and a Macroeconomic Framework Statement, along with the Annual Financial Statement and Demand.
- The Finance Minister to make a quarterly review of the trends in receipts in relation to the Budget and place the review before Parliament.

The Rules

- Gross fiscal deficit to be reduced by 0.3 per cent or more of GDP every year, beginning 2004–05, so that it did not exceed 3 per cent of GDP by end of March 2008 (later extended to end of March 2009).
- Revenue deficit to be reduced by 0.5 per cent or more of GDP at the end of each year, beginning 2004–05, to achieve elimination by 31 March 2008, as prescribed in the FRBM Act (later extended to end of March 2009).
- Contingent liabilities: The central government shall not give guarantees aggregating to an amount exceeding 0.5 per cent of GDP in any financial year, beginning 2004–05.
- Additional liabilities (including external debt at current exchange rate) shall not exceed 9 per cent of GDP for the year 2004–05. In each subsequent year, the limit of 9 per cent of GDP shall be progressively reduced by at least 1 percentage point of GDP.

Changes Implemented by the Reserve Bank following the FRBM Act

The three key provisions of the Act were: (*a*) from 1 April 2006, the Reserve Bank would be prohibited from subscribing to the primary issues of central government securities, (*b*) the government could not borrow from the bank except by way of advances to meet temporary excess of cash disbursements over cash receipts during any financial year following agreements between the government and the Bank and (*c*) the Bank could buy and sell government securities in the secondary market. These provisions could be relaxed in exceptional circumstances.

In the context of the FRBM Act, the Annual Policy Statement for 2005–06 indicated reorientation of government debt management operations, while strengthening monetary operations within the Bank, with a view to moving towards functional separation between debt management and monetary operations. Accordingly, on 6 July 2005, the Bank formed a Financial Markets Department (FMD). Its functions included monetary operations, such as open market operations (OMOs), the liquidity adjustment facility (LAF), standing liquidity facilities and the Market Stabilisation Scheme (MSS); regulation and development of money market instruments such as call/notice/ term money, market repo, collateralised borrowing and lending obligation (CBLO), commercial papers (CPs) and certificates of deposit; and monitoring of money, government securities and forex markets.

The Bank's role in the primary market was supplemented by the more active participation of primary dealers (PDs) (see Chapter 3). PDs undertook to participate regularly in the auctions of newly issued government securities. They bid at the government securities auction either on their own behalf or on behalf of clients and created a secondary market for these securities. They underwrote, made two-way quotes and had access to the call and repo markets for funds. The main sources of funds for the PDs, besides their capital and reserves, were market borrowing, the Bank's liquidity support, borrowings in the repo market and other instruments like CPs and inter-corporate deposits.

On 27 February 2006, the Bank issued guidelines on the expansion of PD business to banks that fulfilled certain minimum eligibility criteria. Operational guidelines, which permitted standalone PDs to diversify their activities in addition to their core business of government securities, were issued on 4 July 2006. Following the report of the Internal Technical Group on

Central Government Securities Market (2005), a revised scheme for obtaining underwriting commitment and providing liquidity support to PDs was introduced in April 2006. This was necessary as the system of annual bidding commitments neither guaranteed that the notified amount would be sold in each auction nor ensured that the cost of issuance was minimised. Accordingly, instead of bidding commitments, PDs were required to underwrite the entire notified amount of an auction.

The Bank, from April 2006, was prohibited from participating in the primary auctions of government securities barring exceptional circumstances. This situation necessitated making changes in the procedures for floatations of government debt. The Bank's role in the primary market (vis-à-vis new floatations) was substituted by more active and direct participation by PDs. Key institutional changes in the payments and settlement system facilitated this transition (see Chapter 8).[13]

Separation of Debt and Monetary Management

An important aspect of debt management is the coordination between monetary and fiscal authorities.[14] The Committee on Capital Account Convertibility[15] advocated separation of debt management from monetary management and recommended the setting up of a separate Office of Public Debt by the government. A working group studied this recommendation of the committee and identified four types of conflict that could arise from the central bank undertaking policy decisions on debt management and monetary management simultaneously.[16] These were: explicit or implicit pressure from the government to monetise fiscal deficit, imposition of large mandatory reserve requirements on banks and financial institutions to reduce the cost of government borrowing, monetary policy being manipulated to complete borrowing programme, and enlarging the volume of short-term debt under expectations of rollovers at lower yields in later years, in effect bringing about distortions in the debt maturity profile. The working group recommended the establishment of an independent company under the Companies Act, 1956, as a wholly owned subsidiary of the Bank, to take over the debt management function.[17]

In the 2000s, more support gathered in favour of separation. The views expressed by various committees are briefly enumerated in Box 7.2.

Box 7.2 Functional Separation of Debt Management from Monetary Management: Views Expressed by Various Committees

Internal Expert Group of the Ministry of Finance (Chairman: A. Virmani, 2001): Recommended a two-stage process to separate the two functions, namely setting up a centralised middle office in the Ministry of Finance to develop a comprehensive risk management framework and then establishing an autonomous Public Debt Office.

Kelkar report submitted to the Ministry of Finance (2004): Emphasised the need for fiscal consolidation and recommended setting up a National Treasury Management Agency, an independent body, distancing the treasury function from the central bank.

High Powered Committee on Making Mumbai an International Financial Centre (Chairman: Percy Mistry, 2007), submitted to the Ministry of Finance: Recommended, among other steps, the creation of a Debt Management Office separate from the Reserve Bank.

Internal Working Group set up by the Ministry of Finance (Chairman: Jahangir Aziz, October 2008): Highlighting internationally accepted best practices, citing, inter alia, the guidelines on public debt management issued by the IMF and the World Bank (in 2003), recommended that debt management should be disaggregated from monetary policy and taken out of the realm of the central bank, and the establishment of a statutory body (that is, the National Treasury Management Agency) to perform debt and cash management.

Also of note were the Committee on Financial Sector Reforms constituted by the Planning Commission (Chairman: Raghuram Rajan, 2009) and the Committee on Financial Sector Assessment, or CFSA (Chairman: Rakesh Mohan, 2009). The chairman of the latter committee did not favour separation of debt management from the Bank.

The Bank, on its part, took the view (about the year 2000) that the separation could be seen as a medium-term goal, subject to meeting three preconditions. These were: development of the securities market, durable fiscal correction and an enabling legislative framework. Governor Jalan, in the Monetary and Credit Policy Statement for 2001–02, observed that since progress had been made on these three fronts, the government and the Bank should consider the feasibility of separating government debt management function from the Bank.

In September 2003, the Ministry of Finance forwarded to the Bank a draft cabinet note on amendments to the RBI Act. The note proposed amendments to Sections 20 and 21, which would take away the management of public debt from the Bank and vest it with the government or an independent body. However, by then, the Bank had modified its stance on the separation issue. Governor Reddy, on 8 September 2004, suggested that the proposal need not be pursued until the macroeconomic environment was conducive to taking such a step.

In the Union Budget speech for 2007–08, the Finance Minister announced the decision to establish an autonomous Debt Management Office (DMO). The 36th meeting of the Monitoring Group on Cash and Debt Management was convened on 22 June 2007 to discuss the setting up of a DMO. D. Subbarao, Secretary (Economic Affairs) at the Ministry of Finance (who later became the Governor of the Reserve Bank), chaired the meeting. From the Bank's side, Deputy Governor Shyamala Gopinath and other officials attended the meeting. The Secretary referred to a 'shared understanding' about the need to move forward with the implementation process. Deputy Governor Gopinath said that the FRBM Act, which restricted the Bank from subscribing to the primary issues, had partly mitigated the conflict between debt and monetary management, and that, given the current ownership structure of public sector banks, a DMO under the Ministry of Finance might give rise to a greater conflict of interest.[18] Acknowledging these points, Secretary Subbarao replied that the issue of separation of the debt management function was a 'settled matter' in the light of the Budget announcement. He added that one of the tasks of the Middle Office was to study international experience and take the advice of all the stakeholders, including the Bank, on an appropriate model for India.[19] The Ministry set up a Middle Office in September 2008 to help 'pilot the evolution of the legal and governance framework appropriate to an independent debt office'.

Management of Central Government Debt

Gross market borrowings of the central government ranged between 3.3 per cent and 6 per cent of GDP between 1997–98 and 2007–08 as shown in Table 7.3.

Table 7.3 Market Borrowings of the Central Government

(₹ billion)

Year	*Gross*	*Net*
1997–98	596.37 (3.8)	404.94 (2.6)
1998–99	939.53 (5.2)	629.03 (3.5)
1999–2000	996.30 (4.9)	730.77 (3.6)
2000–01	1,151.83 (5.3)	737.87 (3.4)
2001–02	1,338.01 (5.7)	923.02 (3.9)
2002–03	1,511.26 (6.0)	1,041.18 (4.1)
2003–04	1,476.36 (5.2)	888.16 (3.1)
2004–05	1,065.01(3.3)	460.50 (1.4)
2005–06	1,600.18 (4.3)	982.37 (2.7)
2006–07	1,793.73 (4.2)	1,112.75 (2.6)
2007–08	1,882.05 (3.8)	1,095.04 (2.2)

Source: RBI, *Handbook of Statistics on the Indian Economy*, various years.

Note: Figures in brackets denote percentages to GDP at current market prices.

During the major part of the period, the generally comfortable liquidity conditions and domestic monetary policy measures helped the transition and facilitated successful completion of the major portion of the borrowing programme during the first half of the financial year. After 2002–03, liquidity conditions continued to be easy due to increased capital inflows. This, together with reductions in the cash reserve ratio and private placements, facilitated the smooth completion of the MBP. In 2003–04, for the first time since the introduction of auctions in primary issuances, the borrowing programme was completed successfully without any devolvement on the Bank. However, in 2004–05, the weighted average cost of market borrowings of the centre as well as states increased marginally after eight years of consecutive decline, reflecting a rise in market interest rates.

The government's net market borrowings in 2004–05 was significantly lower than in the previous year. The state governments prepaid ₹169.43 billion of central government debt through market borrowings, over and above their small saving collections. In addition to the normal market borrowings, the government raised ₹654.81 billion under the MSS for sterilisation purposes. Overall, the net resources raised through government securities compared favourably with the previous year. In the subsequent years, notwithstanding the large-scale borrowing programme of the government, the interest rates remained relatively stable.

Ways and Means Advances to the Central Government

The Reserve Bank granted temporary accommodation to the central government as its banker. This temporary facility is called ways and means advances (WMA). WMA must be cleared within a period of ninety days. When the WMA limit was crossed, the government took recourse to overdrafts, which were not allowed beyond ten consecutive working days. The limits for WMA were mutually decided by the Bank and the Government of India, taking into account the prevailing circumstances (Table 7.4) (also see Chapter 3).

The WMA scheme for the government came into effect from 1 April 1997, after the system of ad hoc T-bills to finance the government deficit came to an end, as part of the Supplemental Agreement entered between the Bank and the government. From 1 April 1999, interest rates on WMA were revised to the Bank Rate and on overdrafts beyond the WMA to the Bank Rate plus 2 percentage points. The transition period of two years to provide for the implementation of the overdraft regulation came to an end on 31 March 1999. The minimum balance required to be maintained by the Government of India with the Bank was to be not less than ₹1 billion on Fridays, on 31 March (the date of closure of the government's financial year) and on 30 June (the date of closure of the annual accounts of the Bank), and not less than ₹0.1 billion on other days.

Table 7.4 WMA Limits for the Central Government

(₹ billion)

Year	*April–September*		*October–March*	
1997–98	120		80	
1998–99	110		70	
1999–2000	110		70	
2000–01	110		70	
2001–02	100		60	
2002–03	100		60	
2003–04	100		60	
2004–05	100		60	
2005–06	100		60	
2006–07	Q1	Q2	Q3	Q4
	200	100	60	60
2007–08	200		60	

Source: RBI, *Annual Report*, various years.

During the major part of 1997–98, the centre did not need to resort to WMA. In 1998–99, the centre's finances remained under pressure throughout, necessitating WMA on a continuous basis for the major part of the year. The government took recourse to overdraft on eleven occasions. The net Reserve Bank credit to the government declined (by ₹5.59 billion) during 1999–2000, for the first time since 1977–78. From the middle of December 2002 to 31 March 2003, the government consistently maintained a surplus balance with the Bank mainly due to increased T-bill issuance, repayments by states under the debt swap scheme (DSS) (mentioned later) and higher inflows due to Relief Bonds. The surpluses were invested in the dated securities transferred from the Bank's investment account. Again, from 8 August 2003 to 29 April 2004, the government continuously maintained a surplus cash balance in its current account with the Bank, mainly due to substantial inflows on account of the DSS and increased issuance of T-bills.[20] The government took recourse to WMA on several occasions until 9 September 2004 but maintained a surplus cash balance in the remaining part of 2004–05.

In view of the Bank's need to preserve its existing stock of securities for the conduct of monetary policy operations, investment of the government's surplus cash balances was temporarily discontinued from 8 April 2004. From 12 June 2004, the arrangement of investment of surplus balances was partially restored for investment up to ₹100 billion due to a reduction in the outstanding under the LAF, partly facilitated by absorption under the MSS. This limit was increased to ₹200 billion from 14 October 2004. The government did not resort to overdraft during fiscal 2005–06 due to the cash build-up, reflecting the investment of state governments in the 14-day intermediate T-bills (ITBs) and auction T-bills (ATBs).

With the Bank withdrawing from participation in the primary issues of government securities from 1 April 2006, WMA limits were revised from 2006–07 in consultation with the government. The limits for 2006–07 were fixed on a quarterly basis, instead of a half-yearly basis. Interest rates on WMA and overdrafts were linked to the repo rate against the Bank Rate, as the repo rate emerged as the short-term reference rate. The interest rate on WMA was at the repo rate and that on overdraft at repo rate plus 2 percentage points.

The liquidity position of the government remained comfortable during 2006–07, even though the surplus cash balances of the centre dwindled during April 2006 and the centre used WMA during May–August 2006. But the centre did not resort to overdraft during the year. The surplus balance with the Bank reached a historic peak of ₹777.26 billion on 22 March 2007, reflecting the state governments' investments in T-bills and buoyancy in advance tax collections. Again in 2007–08, the liquidity position of the government was comfortable in general though there were some pressures during the first quarter of the year and in July 2007.

Diversification of Investor Base

Traditionally banks and insurance companies invested in government securities. These entities held securities in compliance with statutory requirements, whereas the Bank held these securities in its role as the monetary authority and banker to the government. Ownership data for twelve years show an increase in the holdings of other market participants, even though commercial banks continued to account for the largest share of holdings, followed by the Life Insurance Corporation of India (LIC). The statutory liquidity ratio (SLR) requirement for commercial banks was reduced from 38.5 per cent in 1991 to 25 per cent by 1997. Their holding of government securities broadly varied between 50 per cent and 60 per cent (Table 7.5). The lower share of commercial banks in 2004–05 and 2005–06 reflected the increased participation of other insurance companies besides pension funds and provident funds. The outstanding stock of dated securities with the Bank showed a sharp decline from 10.7 per cent at the end of March 1998 to 4.1 per cent at the end of March 2004 but recovered to 7.2 per cent at the end of March 2008. The Bank, however, held a significant volume of government papers in non-marketable form, that is, in the form of ad hoc T-bills up to March 1997. Subsequently, these were converted into marketable dated securities (see Box 7.3).

Table 7.5 Ownership of Central and State Government Dated Securities

(per cent)

End March	*RBI (Own Account)*	*Commercial Banks*	*LIC, GIC and Subsidiaries*	*Others*	*Total*
1997	2.8	67.3	18.7	11.3	100
1998	10.7	58.9	18.0	12.5	100
1999	9.1	59.5	17.9	13.5	100
2000	7.0	60.9	18.1	14.1	100
2001	7.7	61.0	18.3	13.1	100
2002	6.4	60.6	19.6	13.4	100
2003	6.6	58.6	19.4	15.5	100
2004	4.1	56.1	19.4	20.4	100
2005	5.2	52.4	20.5	21.9	100
2006	5.0	46.5	22.2	26.4	100
2007	7.5	46.9	22.5	23.1	100
2008	7.2	50.8	21.1	20.9	100

Source: RBI, *Handbook of Statistics on the Indian Economy*, various issues.

Notes: Central and state government securities represent face value of interest-bearing outstanding rupee securities, excluding T-bills, saving prize bonds, expired loans and interest-free non-negotiable securities of the Government of India; 'Others' category includes provident funds, PDs (from 2001) and all-India and some state-level financial institutions/corporations/institutions.

Box 7.3 Conversion of Special Securities into Marketable Dated Securities

The Committee to Examine the Modalities for Phasing out of ad hoc T-bills from April 1997 (Chairman: Y. V. Reddy) in its report submitted in January 1997 recommended, inter alia, that in the medium term, special securities could be converted into marketable securities in convenient lots as and when the need arose, to facilitate the Bank's OMOs. However, such a conversion mechanism should be so structured that it is substantively expenditure/revenue neutral to the government. Keeping in view the recommendations of the committee, these special (undated) securities were fully converted into marketable dated securities during 1997–98, 2002–03 and 2003–04 (Table 7.6). The proposal to implement such conversion, however, dated back to 1995. On the second such occasion, the Bank found that the entire remaining stock of special securities of ₹1,018.18 billion was kept with the Issue Department as a back-up for note issue. The Internal Debt Management Cell (IDMC) took up the issue with the Department of External Investments and Operations and the Department of Government and Bank Accounts to explore whether the corresponding amount of foreign currency assets could be transferred to the Issue Department. Once these departments agreed, the conversion went ahead.

The steps used for the purpose were the following: (*a*) issue of new dated securities to the Bank against redemption value of an equivalent amount of special securities on the day of conversion, (*b*) the coupon of the new marketable dated securities thus created was fixed on the basis of the market yield prevailing on the date of conversion and (*c*) the interest differential, that is, the difference between the coupon rate of a new marketable dated security and 4.6 per cent (coupon on special security) was borne by the Bank and passed on to the government as part of the annual surplus transfer. Following the recommendations of the committee, the process of conversion had been designed in such a manner that the expenditure impact of the conversion for the government got substantively neutralised by the matching inflows from the Bank in the form of interest differential. Conversion increased repayment liabilities of the government as the perpetual special securities got converted into dated securities at higher coupons with a certain maturity date.

Table 7.6 Conversion of Special Securities into Marketable Securities

(₹ billion)

Date	*Amount*	*Rate (per cent)*	*Tenor (years)*
1997–98			
3 June 1997	50	13.05	10
18 June 1997	50	12.59	7
12 August 1997	50	11.19	8
1 September 1997	50	11.5	5
	200		
2002–03			
16 April 2002	50	7.37	12
	50	7.49	15
3 September 2002	30	6.18	3
	40	7.27	11
	30	7.38	13
2 January 2003	40	5.73	5
	50	5.87	7
	60	6.25	15
	50	6.25	17
	400		
2003–04			
12 June 2003	50	5.48	6
	70	6.05	16
	80	6.17	20
28 August 2003	35	4.83	3
	45	4.88	5
	110	5.87	19
25 September 2003	61.3	5.69	15
	166.88	5.97	22
	618.18		
Grand Total	1,218.18		

Source: RBI.

Changes in Maturity Structure

Around 1997–98, the high overhang of public debt and market expectations of a high interest rate premium on longer-maturity debt encouraged borrowings at the short end of the market to minimise the cost of borrowing. Consequently, the share of shorter-maturity market loans (loans maturing within a period of five years) in the total outstanding market loans stood at 41 per cent at the end of March 1997 against 8.6 per cent at the end of March 1991.

On 23 June 1999, the *Economic Times* observed that the government would have to stretch the maturity profile of its borrowing programme to ensure that it retained control over the redemption obligations in the next few years. Deputy Governor Reddy asked for comments from the IDMC of the Bank. A review was done in the IDMC twice, in June 1999 and July 1999. The first review (in June 1999) observed that until 1996–97, mainly the 91-day ad hoc T-bills used to serve as the residual source of borrowing. With the discontinuation of ad hoc and tap T-bills, the role of the residual source of borrowing shifted to the MBP. The growing borrowing requirements together with the resort to short-term borrowings created problems of refinancing the loans at the time of maturity.

The review noted that in the late 1990s, the Bank realised that there were opportunities to stretch the maturity profile. But the feeling that the market would not welcome a loan with a tenor of more than ten years inhibited the Bank from taking any step. During 1997–98, a decision was taken to test the market with long-dated security, and surprisingly the market welcomed the decision. A spate of long-term issues was not feasible, however.[21] The IDMC suggested that long-dated securities might be linked to short-term rates, that is, issuance of floating rate paper. However, in the absence of a reliable and acceptable short-term refinance rate, issuance of floating rate paper was not feasible. Deputy Governor Reddy proposed 'a reset' after five and ten years at secondary market yields of the remaining maturity at that time, which the IDMC examined.

The idea behind the proposal was that the interest cost could be minimised while issuing long-dated securities by linking the coupon rate to the short-term reference rate. This was possible when the interest rates were expected to fall. However, the experience in the past of the issue of floating rate bonds (FRBs) had not been encouraging.[22] Since the FRBs were issued during a high interest rate regime, the floor rate (minimum return) had to be set high. Thus, the government ended up paying coupons for this five-year paper in the range of 14.26 per cent (much above the peak ten-year government bond rate) and 13 per cent (the floor rate). A reliable short-term benchmark rate, therefore, was necessary.

Another alternative considered was resetting interest rates by means of a call option in the offer document. The government's finances should enable the call-back of any security if such a move was desired in the event of falling interest rates. A call option involved an extra cost, especially in the absence of a put option, and a put option might not be suitable for the government. Further, issues with call option had the tendency to distort the maturity profile of government debt and impinge upon its cash management efforts.

The Chief General Manager of the IDMC reported (office note dated 17 July 1999) that the proposal to issue a longer-term paper, with interest reset every three or five years on the basis of the prevailing three- or five-year yields, was discussed 'discreetly' with a few market participants and the response was encouraging, especially from banks that had a large chunk of three-year fixed rate deposit liabilities.[23]

> The proposal is, therefore, to issue a 15-year bond with coupon at the prevailing 3-year yield (around 11.00 percent) plus some compensation for locking liquidity for 15 years [say, 10 to 15 basis points, or bps] issued *at par on tap basis*. We may not notify the amount and test the market on tap basis with pre-determined coupon for the three-year period minimizing uncertainty surrounding an auction....

Deputy Governor Reddy responded that the proposal was worth trying after discussing the matter with the Ministry of Finance, 'urgently with no firm commitment now'. The matter was discussed with the Ministry officials. A further issue of ten-year paper by auction was to be considered with no floors or call/put options.

To get over the rollover risk (which arose from bunching and redemption in the medium term), the Bank introduced long-term securities of eleven–twenty-year maturity during 1998–99. To ensure that long-term rates remained within a reasonable band, long-maturity stocks were initially privately placed with the Bank and then offloaded to the market through the sale window of the Bank.[24] The weighted average maturity of bonds issued during a year increased from 6.6 years in 1997–98 to 16.9 years by the end of 2005–06 but then declined to 14.9 years (Table 7.7). The weighted average maturity of the outstanding stock increased too. With the fall in interest rates, a comfortable liquidity position and an accommodative monetary policy, the Bank could increase the maturity profile of new debt, while reducing the cost of borrowing at the same time (Table 7.8).

Table 7.7 Weighted Average Yield and Maturity of New Market Loans of the Central Government (Excluding Issues under MSS)

Year	*Weighted Average Yield (per cent)*	*Range of Maturity (years)*	*Weighted Average Maturity (years)*	*Weighted Average Maturity of Outstanding Stock (years)*
1997–98	12.01	3–10	6.6	6.5
1998–99	11.86	2–20	7.7	6.3
1999–2000	11.77	5–19	12.6	7.1
2000–01	10.95	2–20	10.6	7.5
2001–02	9.44	5–25	14.3	8.2
2002–03	7.34	7–30	13.8	8.9
2003–04	5.71	4–30	14.9	9.8
2004–05	6.11	5–30	14.1	9.6
2005–06	7.34	5–30	16.9	9.9
2006–07	7.89	4–30	14.7	10.0
2007–08	8.12	6–29	14.9	10.6

Source: RBI, *Annual Report*, various years.

Table 7.8 Maturity Profile of Central Government Dated Securities (Excluding Issues under MSS): Relative Shares

(per cent)

Year	*Issued during the Year*			*Outstanding Stock*		
	Under 5 Years	*5–10 Years*	*Over 10 Years*	*Under 5 Years*	*5–10 Years*	*Over 10 Years*
1997–98	18	82	0	41	41	18
1998–99	18	68	14	41	42	16
1999–2000	0	35	65	37	39	24
2000–01	6	41	53	27	47	26
2001–02	2	24	74	31	36	33
2002–03	0	36	64	26	35	39
2003–04	5	15	80	24	32	44
2004–05	11	11	78	27	30	43
2005–06	0	26	74	26	31	43
2006–07	7	47	46	26	41	33
2007–08	0	57	43	20	44	36

Source: RBI, *Annual Report, 2007–08*.

As debt manager, the Bank had the obligation of minimising the cost of borrowing to the government. Normally, with an upward sloping yield curve, the longer the maturity, the higher the cost, and this would mean a trade-off between the tenor of borrowing and its cost.

Floating Rate Bonds and Bonds with Call and Put Options

FRBs were first issued by the Government of India on 29 September 1995 and these matured in December 2002. FRBs are medium- to long-term debt instruments offering variable coupons linked to some prefixed benchmark. Inflation protection was available only for the principal and not the interest payment. As the first issue failed to generate a good response, no further issue of FRBs was undertaken for nearly six years. On 21 November 2001, FRBs were reintroduced with some modifications in the structure. The market response was initially good but a few years later, there was a drop in interest, attributed to strong credit pick-up, low secondary market liquidity in FRBs and complex pricing followed by market participants. The issuance of FRBs was discontinued in 2005–06.

As a further step towards diversification, the government introduced capital-indexed bonds of five-year maturity bearing 6 per cent interest for the first time on 29 December 1997. This instrument had the provision for a complete hedge against inflation for the principal amount. There was no further issuance of these bonds mainly due to lack of response of market participants for this type of instrument.

The first government bond with call and put options, the 6.72 per cent government securities 2012, was issued on 16 July 2002 for a maturity of ten years, maturing on 18 July 2012. The option on the bond could be exercised after completion of five years from the date of issuance on any coupon date falling thereafter. The government had the right to buy the bond (call option) at par value (equal to the face value), while the investor had the right to sell the bond (put option) to the government at par value on any day of the half-yearly coupon dates starting from 18 July 2007.

Liquidity of Securities

One of the key issues in the development of the government securities market was the liquidity of securities. In the long list of securities, only a few were actively traded in the secondary market. A policy of passive consolidation through reissue/reopening was started in 1999 to improve the fungibility among securities and to facilitate the consolidation of debt. The strategy took the form of raising the progressively higher share of market borrowings by reissue, and elongation of the yield curve up to thirty years. However, active consolidation could not be resorted to due to administrative costs and legal considerations. In the years when interest rates were lower than in the past, buying back old securities involved payment of premia, which had to be provided for in the Budget. Banks and other institutional investors often held the high-yield securities in their 'held-to-maturity' portfolios, which were, therefore, not often advisable to be bought back.[25] The fall in yields and the resultant steep premia in many cases deterred 'buy-and-hold' investors from subscribing to existing securities.

Debt Swap 2003–04

In January 2003, the Bank made a proposal to swap low-cost debt at current yields with banks holding high-yield government securities.[26] The expectation was that if high-coupon debt was swapped with low-coupon debt at prevailing yields, that is, at market prices, the gains to the government from lower interest would be exactly offset by the premia the government would have to pay to the high-coupon bondholders, and the net present value of the cash flows under both streams would be exactly equal. Cash outflows in the initial years would be higher and in subsequent years lower. For the banks, high-yield bonds enabled them to preserve their net earnings and the unrealised appreciation on these bonds acted as a cushion for future interest rate shocks. However, the high-coupon securities they held were not sufficiently liquid. In case the government could purchase its high-coupon bonds at a discount and reissue fresh bonds at lower yields without any impact on market yield, the transaction would be clearly advantageous to the government. But if the quantum of such swaps that banks were willing to do was not large, the gains would not be large either.

The first buyback auction was conducted on 19 July 2003 for nineteen high coupons but relatively illiquid Government of India dated securities through a live interactive platform where participants could revise their bids. In all, 131 offers were received. The entire amount was accepted as the offers were at or above the minimum discount of 7.5 per cent (to the market value) expected by the government. The market value of the securities bought back was ₹193.94 billion. The difference between the market value and the face value (₹49.60 billion) was shared between the government and the market participants. While the premium paid to the market participants amounted to ₹34.72 billion, the government saved ₹14.88 billion or 7.67 per cent of the market value. In exchange for the securities bought back, the government reissued four existing liquid securities of equal face value (₹144.34 billion). The prices at which the securities were reissued were the weighted average prices during the period 14–18 July 2003. Banks were allowed an additional deduction for tax purposes to the extent such income was used for provisioning of non-performing assets (bad debt).

The government proposed to repay foreign currency loans by purchasing foreign exchange from the Reserve Bank with the rupee funds generated through additional borrowing, initially through a private placement with the Bank. The two foreign currency loans under consideration were the Asian Development Bank loan of US$1,254 million with residual maturity of 11.24 years and rate of interest of 6.34 per cent, and the International Bank for Reconstruction and Development loan of US$1,549 million with residual maturity of 8.44 years and a rate of interest of 5.02 per cent. The Bank's perception was that from the country's perspective, prepaying external debt through the use of foreign exchange reserves seemed to 'make sense' as the return on the reserves was less than the interest rate on the debt.[27]

The Union Budget for 2003–04 announced a DSS to enable state governments to substitute their high-cost loans from the centre with fresh market borrowings and a portion of small saving transfers. Of the total debt swapped (₹604 billion), 61 per cent was financed through additional market borrowings at interest rates below 6.5 per cent, and the remaining through the issue of special securities to the National Small Savings Fund (NSSF) with the interest rate fixed at 9.5 per cent. The receipts under the scheme were used by the government to partially redeem the special securities issued to the NSSF at the time of its inception in 1999. The NSSF, in turn, reinvested the funds in fresh central government special securities in 2003–04 at market-related interest rates.

Debt Consolidation

From the late 1990s, the Bank followed a policy of passive consolidation of government dated securities through the reissue of existing securities. Of the

188 outstanding securities issued by the central government by July 2005, 15 had a size of ₹150 million or more, and these together accounted for 29 per cent of the total stock of central government securities. Thus, while reissue had achieved some degree of consolidation, there were many small-sized securities, very few of which were actively traded in the market.

A faster way to consolidate stock would be through the process of active consolidation. This process would involve, in one form or other, buying back a large number of small-sized illiquid central government securities from the existing holders and issuing a smaller number of liquid securities in exchange. These large-sized securities would be held across a wider base of market participants, which would improve the availability of floating stock and stimulate trading.[28]

The debt buyback scheme, introduced for a short period in July 2003 (see earlier) under the debt restructuring programme of the government, had an element of active consolidation. In the 28th meeting of the Monitoring Group on Cash and Debt Management of the Government of India (13 May 2005), the proposal was taken up for discussion. Deputy Governor Gopinath indicated that the Bank had the experience of buying back of securities in July 2003. However, V. S. Chauhan, Deputy Secretary (Budget), cautioned that the buyback operation had implications for the fiscal deficit and would require provisions in the Budget Demand for Grants/Appropriations in the event of a buyback. The group decided to explore international experience.

A concept note prepared by the Internal Debt Management Department (IDMD) in June 2005 identified several problems with debt consolidation.[29] In a letter dated 5 August 2005 to the Finance Secretary, Deputy Governor Gopinath explained the case for buyback. The case was that since the Bank was to withdraw from the primary market, for effective debt management it was necessary to ensure that securities traded 'in a deep and liquid market', which would require active consolidation of government securities. The government agreed 'in principle' to implement a scheme for active consolidation (letter dated 7 February 2006), subject to certain considerations. The proposal was that the Bank would participate in the primary government securities market, focus on the liquidation of nineteen securities maturing between 2009 and 2015, and link the consolidation proposal with other debt restructuring proposals under consideration.[30]

Subsequently, the government advised the Bank that, given the expenditure pressure during the current year, it was not a good time to initiate active consolidation and suggested that the Bank explore the possibility of working out an initial consolidation package that would have no net negative fiscal impact.[31] The government also made several suggestions for revision of the scheme.[32] The government's view was that a reference to buyback 'depending on funding requirements and market conditions' might create confusion in the minds of investors. Such a step could imply that it was open to the Bank to delay payment for bought back securities, citing market conditions. Further, a suggestion was made for insertion of a clause enabling the Bank to cancel an announcement to meet sudden market situations. The government also proposed some changes in the accounting arrangement for consolidation.

On 4 January 2007, the Bank forwarded the revised draft scheme, incorporating the suggestions except one. This was the insertion of a clause enabling the Bank to cancel an announcement regarding buyback or not accepting an offer for buyback after the same was received without assigning any reason. The government accepted the draft on 31 January.

In October 2007, the IDMD sent the government a list of securities identified for buyback. Two days later (31 October 2007), the government replied that it agreed to put the final scheme in the public domain. There was then a lull for about two months. On 19 February 2008, the Chief General Manager, IDMD, spoke to the Additional Secretary (Budget Division) indicating that the time was not appropriate for the buyback because the yields were hardening and liquidity in the market was tight. The Additional Secretary agreed to defer the consolidation. Eventually, the scheme did not get off the ground during the reference period.

Monitoring Group on Cash and Debt Management

With the discontinuance of the ad hoc T-bills and introduction of the new scheme of WMA (April 1997), a new monitoring mechanism was needed. The mechanism would transmit signals when 75 per cent of the WMA limit was utilised by the Government of India so that the Bank could float fresh government securities. The Ministry of Finance formed a Group on Monitoring of Cash and Debt Management on 28 April 1997 to discuss this.[33] The terms of reference of the group were quite wide, and included estimating the monthly fiscal deficit of the government and the associated borrowing requirement at the start of the year, recommending the proper timing, amount and instrument of borrowing, reviewing the cash position of the government, creating a database for advance estimation of monthly revenues, and streamlining the flow of information to the Bank from banks and other agencies. From its start until March 2008, thirty-eight meetings of the monitoring group had taken place (see Table 7.9).

Table 7.9 Monitoring Group on Cash and Debt Management of the Central Government: Illustrative List of Subjects Discussed at the Meetings

Routine Matters	*Policy Matters*	*Special Subjects*
WMA position of the central government.	Raising market loans of longer maturities.	Establishment of a consolidated sinking fund (CSF) for the central government.
Review of trends in government finances and the current fiscal situation.	The possibility of borrowing through instruments like capital-indexed bonds, deep discount bonds and floating rate bonds.	Transition to a new regime governed by the FRBM Act, 2003.
Fixation of WMA limits (annual, half year/quarter).	MBP of state governments.	Setting up of a DMO and, in the first phase, a Middle Office (MO) to facilitate the transition to a full-fledged DMO.
Borrowing programme for the first half year/second half year.	Issues relating to the Special Deposit Scheme, 1975.	
Preparation of advance (indicative) half-yearly calendar for floatation of market loans (Appendix 7A.3).	Investments of surplus cash balances of state governments and its implications for the centre's cash management.	
Schedule of auctions for 364-day T-bills.		
Finalisation of an auction of T-bills under normal MBP.		

(*Contd.*)

(*Contd.*)

Routine Matters	*Policy Matters*	*Special Subjects*
Daily mismatches between receipts and payments in respect of railways, defence, telecommunication and posts.		
Non-receipt of drawing schedules from various accountants of the ministries of the central government.		

Management of State Government Debt

Market Borrowing Programme

The Reserve Bank entered into agreements with state governments under Section 21A of the RBI Act to manage their public debt. The Bank's role as debt manager for state governments is voluntary. State governments are not allowed to borrow from abroad.

Managing the market borrowing programme at the state government level was a two-stage process. The Government of India and the Planning Commission set annual allocations to the individual state governments under the annual MBP. The next stage involved floatation of loans in the government securities market by the respective state governments, and decisions on timing, amount of each issue and coupon rate. The Bank was involved in this stage and decided these matters in consultation with the state governments.

Until 1998, the Bank conducted the combined borrowing programme of states in two or more tranches in a year through the issue of bonds with predetermined coupon and pre-notified amounts for each state. The relatively high SLR and the small size of state borrowings ensured that these primary issues would be completed successfully. However, the progressive reduction in the SLR, which left several banks with excess SLR securities in their investment portfolio, and perceptions of investors about the loans being raised by individual states, created problems.

Following a review in 1997, the Bank decided to enable the better-managed states to access funds at market rates. State governments could now enter the market individually to raise resources using the auction method or tap method to raise between 5 per cent and 35 per cent of the allocated market borrowings. Some states were able to mobilise loans at competitive rates, while others had to pay higher rates, depending on their fiscal health and track record (Table 7.10).

In 1997–98 and 1998–99, MBPs of the states were conducted smoothly. In the second tranche conducted on 8 September 1999, while loans of thirteen states were oversubscribed, those for ten states initially remained undersubscribed. Under such circumstances, the Bank used to persuade major players to reallocate their excess subscriptions with some states to the deficit states. However, on this occasion, the Executive Director (Investment) of LIC wrote back to the Bank (4 November 1999): '[W]e request you to make allotments in future to individual States within our subscription applied for and

Table 7.10 Market Borrowings of the State Governments

(₹ billion)

Year	*Gross (Per Cent of GDP at Market Prices)*	*Net (Per Cent of GDP at Market Prices)*
1997–98	77.49 (0.49)	71.93 (0.46)
1998–99	121.14 (0.67)	107.00 (0.59)
1999–2000	137.06 (0.68)	124.05 (0.61)
2000–01	133.00 (0.61)	128.80 (0.59)
2001–02	187.07 (0.79)	172.61 (0.73)
2002–03	308.53 (1.22)	290.64 (1.15)
2003–04	505.21 (1.78)	463.76 (1.63)
2004–05	391.01 (1.21)	339.78 (1.05)
2005–06	217.29 (0.59)	154.55 (0.42)
2006–07	208.25 (0.48)	142.74 (0.33)
2007–08	677.79 (1.36)	562.24 (1.13)

Source: RBI, *Handbook of Statistics on Indian Economy*, various years.

Note: Gross market borrowings of the states included additional market borrowings of ₹100 billion for 2002–03, ₹266.23 billion for 2003–04 and ₹169.43 billion for 2004–05 under the states' DSS.

in no State the allotment should exceed the subscription applied for.' Deputy Governor Reddy informed the Finance Ministry of this request, adding that, in effect, it meant that the Bank would not be able to use 'persuasion' to divert surplus subscriptions. A different approach was needed.

A letter written on 4 January 2000 reflects this transition especially well.[34] The letter explained the three options available to the states to enter the market. The first option was to raise the balance amount of the loan from the market at a fixed coupon. The subscription received would depend on the extent to which banks and financial institutions were prepared to invest at the yield offered. There was a risk of undersubscription. The second method was an auction with flexibility in terms of maturity, timing and interest rate. The rate at which the state could raise full subscription depended on the rates of interest at which the institutions were prepared to invest. There was a risk of higher interest rates. The third route was a tap issue at a fixed coupon without specifying the notified amount. The tap was to be closed as soon as the required amount was received within a reasonable period. The amount received would depend on the coupon offered, market conditions and the interest shown by institutions. There was again a risk of undersubscription. The uncertainties about the subscription amount and the rate of interest could be moderated by recourse to underwriting. The state governments were cautioned that in all of the three options, there was a possible reputational risk that should not be ignored. 'Let me assure you,' the letter concluded, 'that RBI would, as always, strive to make the issues of State Governments a success, but it is necessary to recognize the changing sentiments of market participants especially institutional investors like banks regarding the relative creditworthiness of individual States.'

The year 2000–01 saw huge shortfalls in subscriptions to individual state development loans (SDLs). It was with great difficulty that the undersubscribed loans of some states could be made up with the cooperation of banks and financial institutions, at the initiative of the Reserve Bank. The IDMC identified several reasons for this.[35] There were persistent defaults in payment of interest and principal on state-guaranteed bonds by some states. There were defaults in payment of interest on state loans when the payments on behalf of Assam and Manipur were suspended by the Bank under the overdraft regulation scheme. Further, during the previous three years, additional allocations were made to states for one reason or another even after the MBPs for the year had been completed. Even though the Bank offered

25 bps above the Government of India securities rate for the state loans, in absolute terms, the coupon rate offered on state loans had been coming down. In the past, state loans were floated twice or thrice a year, but now the Bank entered the market throughout the year. In 2000–01, state loans were raised on seven occasions. Finally, state government securities had low liquidity and the investors had to hold these investments in their portfolio for a long time.

During 2001–02, while the first tranche in May 2001 went through without any problem, in October 2001, a second tranche loan floated by Assam was undersubscribed. The officials of the Reserve Bank requested banks to make efforts for meeting the shortfall. Some banks agreed with considerable reluctance to reallocate. In a few cases, the Chairmen of the concerned banks contacted the Principal Secretary of Assam and agreed to commit the amounts on the assurance that the state arranged to meet the arrears due to them. Appraising the above developments, the Executive Director of the Bank in a letter (13 October 2001) to the Principal Secretary, Finance Department, Assam, did some plain-speaking and, among other suggestions, 'counseled to meet without delay the state's obligations under guarantees issued by it'. Similar letters went out to two other state governments whose borrowing programmes were under pressure.

A meeting with state Finance Secretaries (26 May 2001) held that the borrowings by states could be raised by tap issuance without announcing the notified amount, to avoid the embarrassment of undersubscription. The tap was to be kept open for one day and closed the moment the intended amount was subscribed or, in the event of undersubscription on the first day, to be extended for a day or even two under exceptional circumstances. If the problem was not resolved, a repeat tap could be considered for the states concerned.

Some states expressed the opinion in a meeting of state Finance Secretaries held on 28 November 2001 that it might not be possible for them to mobilise their borrowings with the spread limited to 25 bps. A few major investors believed that the spread should be higher. These views were discussed at the FMC-RBI of the Bank on 22 January 2002. The consensus was that, based on the approved yield curve rate of 7.86 per cent on 10-year maturity and 43-bp spread, the yield came to 8.29 per cent. Based on this, a yield of 8.30 per cent could be offered for state government tap issuance currently.[36]

The tap issue replaced the traditional tranche method in January 2002. This did not turn out to be of much help. On the first day of the tap issue on 28 January 2002, tap sales for sixteen state governments were closed on receipt of the respective target amounts. Partial allotments were done in respect of five states that were oversubscribed. On the second day, the tap sale for three states was closed on receipt of the respective target amounts. The tap sales for the remaining seven states were closed on the third day, 30 January 2002. But Jammu and Kashmir, Jharkhand, Madhya Pradesh and Meghalaya received a weak response, and the response for Assam, Bihar and Uttar Pradesh was very poor. Efforts were made by contacting investors to fill the gap. Eventually, a substantial portion of the shortfall was bridged.

In 2002–03, a record amount was raised by state governments, in part due to the DSS (mentioned later). The tap sale of 6.75 per cent state loans opened on 12 March 2003 for twenty-six states, and while the tap closed for twenty-three of these two days later, a large shortfall remained in the case of Assam, Rajasthan and West Bengal. Tremendous efforts were made by the IDMC to persuade the institutions to invest in these states. A tap sale of SDLs on 28–29 July 2004 ended with a shortfall for twelve out of nineteen states. In fact, four out of five issues conducted since January 2004 were undersubscribed. The only successful issue in April 2004 rested on subscriptions from the Employees' Provident Fund Organisation (EPFO), which had benefitted from a sudden inflow by way of interest on the Special Deposit Scheme. The magnitude of the shortfall and the number of states involved were disquieting. Deputy Governor Mohan, in his letter of 11 August 2004 to the Finance Secretary, discussed the situation (Appendix 7A.4). The Bank was of the view that the fiscal management of the states needed to improve. Otherwise, states with better track record risked being crowded out and could face higher borrowing cost. The matter was discussed at a meeting arranged by the Finance Secretary on 16 September 2004, attended by officials from the Bank.

There was a dramatic reversal after 2004–05. The fiscal position of states showed remarkable improvement, thanks to greater fiscal discipline and devolution of funds from the centre. Towards the end of our period, states on their own opted for the auction method for borrowing and, on occasions, were not keen to tap the market because of surplus cash position, better cash management, fiscal prudence and funds accrued to them under grants and devolvement.

The first tap tranche of market borrowings for state governments opened on 17 May 2005. The coupon rate for the tap issue had been earlier determined (on 10 May 2005) to be 7.77 per cent per annum, after allowing a spread of 50 bps over the secondary market yield of the ten-year Government of India security. However, during the period of floatation, the spread increased to 60 bps due to a fall in the yield of the ten-year government security. The response for state loans was overwhelming, except for Uttar Pradesh. Initiatives were taken in individual states to improve their capacity to borrow.[37] The third tranche of the MBP for 2005–06 was an overwhelming success.

Following the recommendations of the Twelfth Finance Commission, central loans for state plan schemes were discontinued from 2005–06, and states were encouraged to take the auction route. The share of borrowings by way of auctions increased from 2.3 per cent (three states) in 2004–05 to 48.5 per cent (twenty-four states) in 2005–06 (Table 7.11). Punjab raised the entire amount through an auction. The success of auctions reflected the better market perception of states' fiscal situation and was reflected in the lower spread of cut-off yields vis-à-vis tap issues. Ten states opted not to enter the market in view of their holdings of surplus cash balances.[38]

Sixteen state governments approached the market on 11 May 2005 for a notified amount. The loan amounts were raised through a yield-based auction using a multiple price auction method. Three states exercised the option of underwriting by PDs. The market yield of the ten-year government security stood at 7.53 per cent on the day of the auction. States accepted bids at cut-off rates, with spreads ranging between 34 bps and 52 bps. All state loans received a good response, except that of Meghalaya. The response in subsequent auctions was also considered favourable.

Table 7.11 The Share of Auction in States' MBP

Year	*Share (per cent)*
1998–99	0.5
1999–2000	6.3
2000–01	12.6
2001–02	14.0
2002–03	9.6
2003–04	5.7
2004–05	2.3
2005–06	48.5
2006–07	100.0
2007–08	100.0

Source: RBI.

During 2006–07, borrowings by states were lower than those allocated, mainly because of the build-up of cash balances. For the first time, states raised the entire amount through the auction route, except those that did not participate in the MBP. In general, the spreads of the cut-off yields in the auctions over the secondary market yields of comparable central government securities were lower than those in the previous year. To improve the liquidity of state government securities, in March 2007, these were made eligible as collateral for LAF operations conducted by the Bank. Faced with an accumulation of surplus cash balances, some state governments approached the Bank to arrange for buyback of their outstanding SDLs, which the Bank agreed to. The MBP during 2007–08 was again conducted entirely through the auction route.

Debt Swap of High-Cost Debt of State Governments

The issue of debt swap was discussed earlier. A committee of the government set up to assess the fiscal situation of states (2002) deliberated on a DSS. The Bank's involvement was vital because a decision had to be taken about the quantum of additional market borrowing by state governments to enable them to prepay the loan. A draft scheme was prepared in August 2002. The swaps would involve prepayment of loans from the centre carrying an interest rate of 13 per cent or above. Roughly, 75 per cent of such high-cost loans were loans against small saving collections. State governments could resort to higher market borrowings, subject to the condition that they used 30 per cent of their net small saving receipts to retire high-cost debt.

The scheme was examined by the IDMC in August 2002. Their note was categorical that the prospect of states resorting to higher market borrowings was not only difficult but also dangerous for interest rates and unfair on smaller or better-managed states. In an alternative method proposed, the centre was to unilaterally cut the interest on high-cost loans. This approach had the advantage of reducing the interest burden on states without affecting the market. It was also simpler to administer. Governor Jalan was in favour of solving this politically sensitive problem through discussions with government officials, instead of through correspondence.

Following the above developments, the Bank reiterated that there were difficulties with market borrowings for states in the recent past and that further efforts could raise the cost of borrowing and the risk of under-subscription. The Bank believed that the overall draft on the financial system through market borrowings should be restricted to the amount finalised under the approved MBP for the government, meaning that the increase in the borrowing of the states should match the decline in the amount raised by the centre. The government was of the view that this might be difficult to achieve.[39]

During 2002–03, twenty-five state governments (excluding Maharashtra, Sikkim and West Bengal) swapped high-cost loans amounting to ₹137.66 billion, partly out of small saving collections and partly through fresh market borrowings of ₹100 billion. During 2003–04, states swapped ₹462.11 billion with additional market borrowings of ₹266.23 billion and 30 per cent of small saving transfers. Similarly, during 2004–05, states raised ₹169.43 billion under the scheme.

The Issue of Additional Borrowing

The borrowings of states comprised market loans under the 'approved' borrowing programme, central loans under plan and non-plan and small savings, provident funds, special deposits and other items in the public account, and the securities issued against small savings. Banks were not allowed to finance the expenditure by state governments except through the 'approved' MBP.

The net allocation under the MBP for state governments had gone up even during the period when states enjoyed surplus cash balances. On top of this, there had been additional borrowing by states on account of a variety of reasons, such as drought, flood, DSS, prepayment of the high cost loans, and so on. Further, with the cessation of central loans to state governments from 2005–06, as recommended by the Twelfth Finance Commission, the reliance of states on alternative forms of borrowings also increased.

The Ministry of Finance at times sanctioned additional borrowing to states over and above the approved MBP and the Bank was asked to arrange for open market borrowings accordingly. This caused concern to the Bank.[40] On 20 February 2001, the Bank had issued a letter communicating the approval of the government for additional market borrowing of ₹15 billion for states. Deputy Governor Reddy, in a letter (23 February 2001) to Finance Secretary Ajit Kumar, reiterated the implications of enhancing the borrowing programme, namely a possible rise in interest rates and a shortage of funds with

Table 7.12 Extent of Additional Borrowing by States

Year	*Net Amount Raised (₹ billion)*	*Additional Allocation (₹ billion)*	*The Share of Additional Allocation in Net Amount Raised (per cent)*
1998–99	107.00	13.73	12.8
1999–2000	124.05	19.20	15.5
2000–01	128.80	16.50	12.8
2001–02	172.61	63.82	37.0
2002–03	290.64	163.22	56.2
2003–04	463.76	266.23	57.4
2004–05	339.78	230.02	67.7
2005–06	154.55	35.22	22.8
2006–07	142.74	28.03	19.6
2007–08	562.24	402.34	71.5

Source: RBI, *Annual Report*, various years.

banks. The Bank proposed a reduction of an equivalent amount in the centre's borrowing programme for the current financial year and to pre-announcing it to the market. The government agreed to the proposal.

The share of additional allocation in the net amount raised increased from 12.8 per cent in 1998–99 to 71.8 per cent in 2007–08 (Table 7.12). A large part of such additional borrowing had, however, been on account of the DSS in which states prepaid high-cost debt to the centre and on account of shortfall in collections under the NSSF.

Bank Finance through Special Purpose Vehicles

Special purpose vehicles (SPVs) issued state-guaranteed bonds that were defined as 'negotiated loans' by the Planning Commission. State governments were sometimes allowed to use the method. The Bank, however, was not comfortable. The bonds were usually not rated by rating agencies and were privately placed. In effect, such lending entailed little credit appraisal and appraisal of the project for which the loan was raised. The SPVs were neither serviced by the issuing entity nor honoured by the state government concerned when the guarantee was invoked. If it was to be repaid out of budgetary funds, then a proper appraisal would be needed to assess the finances of the states as well.

The Bank's guidelines regarding financing of projects carried out by public sector units allowed only term loans made by corporate entities. The intention was to enable bank financing of commercially viable projects undertaken by PSUs as a supplement to government financing of such projects. The Bank's view was that for guaranteed loans, there should be credit assessment, possibly by rating agencies.[41]

One example was the West Bengal government, which borrowed on behalf of the West Bengal Industrial Development Corporation and sought direct debit permission from the Bank. A letter from the Bank (25 June 2001) to the Finance Ministry considered 'this not only dilutes the monetary policy management by RBI but also undermines the macroeconomic stability and introduces a non-transparent fiscal burden on State Governments' (See Appendix 7A.5). Towards the end of 2001, the issue was raised again with borrowing by the West Bengal Infrastructure Development Finance Corporation (WBIDFC). The West Bengal government received approval from the Ministry of Finance for borrowing huge amounts outside the approved MBP. As before, the funds were being mobilised from banks on the strength of an automatic debit mechanism with the Bank and an irrevocable mandate by the state government. The total amount approved was ₹48.05 billion over two years, 1999–2000 and 2000–01, which was three times the amount of loans under the MBP. The approvals contained a clearance from the Government of India for conducting the transactions on the terms and conditions agreed upon by the state government and the WBIDFC. The contractual arrangement, including the automatic debit mechanism, created a procedure that could continue in the future. All of this had serious implications for credit, fiscal risk, crowding out, and the Bank's ability to conduct debt management.

The Bank, therefore, instructed its Regional Director, Calcutta (Kolkata), not to allow any automatic debits for loans taken by the state government in future outside the MBP. The West Bengal government was also requested to make direct arrangement for servicing any such loans taken in the future, without routing such arrangements through the Bank. The state government was advised to ask the WBIDFC to disclose to the investors that such automatic debit arrangements with the Bank would not be available in the future. The response from the Government of India to these concerns was positive and helpful.[42]

To streamline the borrowing programme of states, the government decided to adopt a two-stage procedure. First, the Fiscal Reforms Unit of the Department of Expenditure would work out the limits of prudential debt and send it to the Planning Commission. Thereafter, within the allocation approved by the Planning Commission, the Budget Division in the Department of Economic Affairs would give permission, on application by states. Any reallocation by states, within the overall ceiling fixed by the Planning Commission, would require the agreement of the Ministry of Finance and the Planning Commission. For SPVs whose borrowings clearly had to be serviced by the state, prior permission was necessary. In short, SPVs should only fund commercially viable projects, and not become a substitute for the budgetary resource.

In the case of 'negotiated loans', which were arranged from the apex financial institutions for SPVs for financing specific projects, there were two possibilities. If they did not enter the Consolidated Fund, there was only a sort of contingent liability. If they did enter the Consolidated Fund and were from non-banking sources, directly or indirectly, the issue was one of transparency. Where such loans entered the Consolidated Fund and constituted the direct liabilities of the state government, it was necessary to ensure that such negotiated loans were not raised from banks.

In a meeting chaired by the Finance Minister on 9 September 2003, a decision was taken to allow state governments to borrow from outside the normal MBP – in this case, to assist sugar mills in paying cane arrears. On becoming aware of this development, Deputy Governor Mohan wrote (17 September 2003) to the Finance Secretary reiterating the adverse implications of the move and wanted the Bank to be involved in the scheme.

Special Category States[43]

In the meeting of the Finance Secretaries held on 28 November 2001, there was a proposal from Andhra Pradesh, Gujarat, Maharashtra, Karnataka and Tamil Nadu to extend auction beyond 35 per cent of the tranche. At the same time, there were requests from the special category states for retaining the status quo. The difference reflected the fact that in a deregulated environment, the capacity of states to raise resources differed according to the quality of fiscal management and the depth of the financial services sectors in states. The Bank felt that even under the tap method, it was unlikely that the special category states would receive an adequate response without the comfort of reallocation by banks. In the meeting, a view emerged that there should be a special arrangement for the northeastern states and others.

The MBP of special category states amounted to about 10 per cent of the total borrowing programme of states. Considerable problems were faced by these state governments in interacting with the financial sector because financial services were less developed in these states. The Bank saw merit in a separate policy.[44] However, the government did not agree on grounds of prudent fiscal management.

WMA and Overdrafts

The Bank provided two types of WMA to state governments. The normal WMA were unsecured advances while the special WMA were given against the pledge of central government securities held by state governments. Any amount drawn more than WMA was treated as an overdraft. The use of WMA and overdrafts by states became more frequent from 1997–98.

The WMA limits were doubled from 1 August 1996. The interest rates on WMA and overdrafts were placed at the Bank Rate and 2 percentage points above the Bank Rate, respectively.[45] During 1997–98, sixteen states resorted to overdrafts, and three could not clear their overdrafts with the Bank within the stipulated time limit of ten consecutive working days. Thus, the Bank had to stop payment on behalf of three state governments. One state, in fact, breached the ten-day limit on as many as eight occasions.

In 1998, a committee was asked to consider rationalisation of the WMA scheme.[46] The committee recommended delinking WMA limits from the minimum cash balances, swtiching over to a formula (three-year average of the total revenue receipts and capital expenditures) in the case of normal WMA, adopting a liberal approach for special WMA and not allowing relaxation in the disciplinary mechanism underlying the overdraft regulation scheme. These recommendations were subsequently implemented in 1999 with minor modifications (Table 7.13). The WMA limits were revised a number of times.

Table 7.13 Revisions of WMA Limits for States

Effective Date	*Total for All States (₹ billion)*	*Committee/Annual Revision*
1 March 1999	36.85	Vithal Committee
1 February 2001	52.83	Revised WMA Scheme
3 March 2003	71.70	Ramachandran Committee
1 April 2004	81.40	Annual Revision
1 April 2005	89.37	Annual Revision
1 April 2006	98.75	Bezbaruah Committee
1 April 2007	98.75	Annual Revision

Source: RBI.

Based on the recommendations of the Ramachandran Committee (2002), the basis for determining WMA limits was simplified, and the scheme for overdraft regulation made more stringent. The special WMA continued to be linked to investments made by state governments in the Government of India securities.[47] An Advisory Committee on Ways and Means Advances and Overdrafts of State Governments,[48] in its report submitted on 29 October 2005, observed that there was an improvement in the finances of state governments in recent years, in view of which the normal WMA limits were more than adequate. Based on the recommendations of this committee, a revised WMA scheme was put in place.[49]

From 2003–04, a dramatic reversal set in. The utilisation of WMA and overdrafts by states during 2003–04 was generally lower than that in the previous year. The proceeds from small savings and higher market borrowings contributed to the improvement. The situation further improved during 2004–05 and 2005–06 because of persistent cash surplus with state governments. The average utilisation of special WMA, normal WMA and overdrafts by states governments were lower than in the previous years and there was a reduction in the number of states that utilised normal WMA. The improvement in the overall cash position of states was also reflected in the spurt of investments in fourteen-day ITBs.

There was a downward trend in the daily average utilisation of normal WMA, special WMA and overdrafts by state governments during 2006–07. Only two states resorted to overdraft against eight states in the previous year. Despite the slowdown in the automatic inflow of funds under the high-cost NSSF, most state governments continued to accumulate sizeable cash surpluses, emanating mainly from substantially higher central transfers. During 2007–08, the average utilisation of normal WMA by state governments was high during the first half of the year, but moderated in the second half, particularly in the last quarter. The rise in the surplus cash balances of state governments from the middle of 2004–05 posed a new problem.

Management of States' Surplus Balances

The cash balances of state governments posed a new type of challenge. The existing investment avenues for surplus funds did not offer sufficient returns. The cash balances of state governments were automatically invested in fourteen-day ITBs issued by the central government. The rate of discount on these ITBs was 5 per cent (during August 2007), which was lower than the interest paid out on open market borrowings (8 per cent) and small savings (9.5 per cent). State governments were also permitted to invest as non-competitive bidders in ATBs, earning an interest of 6.5 per cent. At that time, state governments were not permitted to invest in dated government securities, which yielded a higher return (7.8 per cent) than T-bills. Consequently, many state governments expressed the need for alternative investment options for their cash balances. The states' investment in ITBs and ATBs showed up in the cash balances of the government maintained with the Bank, and had implications for monetary management. The existing arrangement needed a review.

The matter was discussed at the 18th Conference of State Finance Secretaries (7 August 2006). Governor Reddy set up a group of state Finance Secretaries and Reserve Bank officials to suggest a framework for alternative investment options.[50] The group made several recommendations that were discussed during the 20th Conference of State Finance Secretaries held on 24 August 2007. These discussions, however, extended beyond the reference period.

While most states preferred to curtail the size of their market borrowing, Odisha, Tamil Nadu and Rajasthan prepaid their high-cost outstanding loans, including those from the NSSF during 2006–07 and 2007–08. Karnataka and Tamil Nadu also opted to buy back their entire outstanding under power bonds issued to central public sector power bond liabilities. Further, four states, namely Chhattisgarh, Haryana, Odisha and Tripura, with surplus cash balances did not raise market borrowings during 2007–08, reflecting their prudent cash and debt management. Yet there were as many as sixteen states that resorted to market borrowings during 2007–08 even when they enjoyed a build-up of surplus balances.[51]

Model Fiscal Responsibility Legislation at the State Level

In view of the persistent concern over fiscal management of states in the first half of the 2000s, five state governments enacted legislation on fiscal responsibility and budget management. These Acts were the Karnataka Fiscal Responsibility Act, 2002; the Kerala Fiscal Responsibility Act, 2003; the Punjab Fiscal Responsibility and Budget Management Act, 2003; the Tamil Nadu Fiscal Responsibility Act, 2003; and the Uttar Pradesh Fiscal Responsibility Act, 2004. Interestingly, the enactment of fiscal responsibility legislation at the state level preceded that of the central government. These laws made the respective state governments responsible for ensuring fiscal stability, intergenerational equity and financial stability by achieving revenue surplus, containing fiscal deficit and maintaining a sustainable debt level (Table 7.14).

The 12th Conference of State Finance Secretaries, at its meeting held on 1 August 2003, decided to draft a report on a model fiscal responsibility bill for state governments.[52] The Bank provided technical assistance in the preparation of the report. A group was formed in October 2003 with the state Finance Secretaries of Kerala, Karnataka, Maharashtra, Punjab, Tamil Nadu and a representative from the Ministry of Finance, Government of India, as members. The Secretariat was provided by the IDMD of the Bank. A model law was drafted after the central FRBM Act and built upon the state fiscal responsibility legislation enacted already.[53]

Other Issues Concerning Public Debt Management

Special Securities

The central government issued special securities to several entities, such as the oil marketing companies, fertiliser companies, the Food Corporation of India (FCI), the erstwhile IDBI, Unit Trust of India and State Bank of India (SBI). Such securities were issued to settle the outstanding dues of the government and not reckoned for the fiscal deficit. These, however, increased

Table 7.14 Major Deficit Indicators of State Governments

(per cent of GDP at market prices)

Year	*Gross Fiscal Deficit*	*Primary Deficit*	*Revenue Deficit*
1990–91	3.2	1.7	0.9
1991–92	2.8	1.2	0.8
1992–93	2.7	1.0	0.7
1993–94	2.3	0.5	0.4
1994–95	2.6	0.8	0.6
1995–96	2.5	0.7	0.7
1996–97	2.6	0.8	1.2
1997–98	2.8	0.9	1.1
1998–99	4.1	2.1	2.5
1999–2000	4.5	2.2	2.7
2000–01	4.0	1.7	2.5
2001–02	4.0	1.4	2.6
2002–03	3.9	1.2	2.3
2003–04	4.2	1.4	2.2
2004–05	3.3	0.7	1.2
2005–06	2.4	0.2	0.2
2006–07	1.8	-0.4	-0.6
2007–08	1.5	-0.5	-0.9

Source: RBI, *Handbook of Statistics on Indian Economy*.

Notes: Gross Fiscal Deficit (GFD) = Excess of total expenditure (including loans net of recovery) over revenue receipts (including grants) and non-debt capital receipt. Since 1999–2000, GFD excludes states' share in small savings. Primary Deficit = GFD minus interest payments. Revenue Deficit = Difference between revenue receipts and revenue expenditure. Negative sign denotes surplus.

the outstanding interest-bearing liabilities of the government and, therefore, prevented the government from adhering to the FRBM targets. These special bonds did not have SLR status as the bonds were not part of the approved MBP; their coupon rates were based on the prevailing secondary market yield of SLR-eligible and comparable government securities, and these were transferable (except oil bonds before 2002) and eligible for market repo but not eligible for repo and reverse repo with the Bank during the reference period.

From March 2002, oil bonds carried full transferability and tradability. However, in 2006–07, the issuance of additional supply of FCI bonds carrying full transferability meant that it would not only increase the cost of the MBP and crowd out private investment but would also result in a likely increase in yield rates. The Bank, therefore, proposed (7 September 2006) that these bonds should carry a limited transferability feature similar to the power bonds (see later).

These special securities were issued in large volume from 2001–02 onwards but gathered momentum from 2006–07 when the FRBM Act, 2003, became operational (Table 7.15). The total volume of special securities amounted to as much as 36 per cent of the net market borrowing of the government in 2006–07. The outstanding amount of special securities at the end of June 2006 was 10 per cent of the outstanding dated marketable securities. The Bank pointed

Table 7.15 Issuance of Special Securities

(₹ billion)

Year	*Special Securities*					*Net Market Borrowing*	*Column 6 as % of Column 7*
	Fertiliser companies	*FCI*	*Oil marketing companies*	*Others**	*Total*		
1	2	3	4	5	6	7	8
2000–01	-	-		1	1	738	0.1
2001–02	-	-	90	4	90	923	10
2002–03	-	-	-	44	44	1041	4
2003–04	-	-	3	3	6	888	1
2004–05	-	-	58	74	131	461	29
2005–06	-	-	115	-	115	982	12
2006–07	-	162	241	-	403	1113	36
2007–08	75	-	206	100	380	1095	35

Source: RBI.

Note: * Special securities issued to Industrial Finance Corporation of India, Industrial Investment Bank of India, SBI, and so on.

out to the government that if these bonds were included in the budget, the fiscal deficit would increase by at least 1 per cent of the GDP in 2006–07. Another interesting feature of these securities was that the maturity of these bonds increased from three–nine years in 2005–06 to nineteen–twenty years in 2006–07 and 2007–08. Although the government explored the feasibility of issuing bonds of lower maturity, as the Bank noted, there was small headroom available when market conditions were not conducive.

Power Bonds

Power bonds were issued to certain central PSUs by the state governments in 2004–05. The scheme was an outcome of the report of the Expert Group on Settlement of State Electricity Board Dues,[54] which recommended the issue of power bonds. The Bank had reservations about the proposal.[55] The inclusion of such bonds in SLR borrowing, the Bank held, did not serve any purpose since most banks had excess SLR. An automatic debit mechanism by way of a tripartite agreement as planned was not desirable and 'virtually inoperable'. The bonds could also crowd out private sector credit.

The scheme was modified in 2002, but the Bank felt that more clarifications were needed. In a letter (3 May 2002) to the Secretary (Expenditure), C. S. Rao, Deputy Governor Reddy pointed out that the proposed power bonds having a coupon that was not aligned with the market, was tax free and had other special features, and could not be serviced in the same manner as other state government bonds issued through the Bank under the approved market borrowing programme. It was, therefore, suggested that these power bonds might be issued and serviced by the states themselves. To the extent the power bonds were released in the market, these were to be set off against the aggregate market borrowings in each year. The Bank was not in favour of the automatic debit mechanism as it eroded the credibility of the state governments.

A meeting took place in Mumbai on 19 July 2002 between the Governor and Suresh Prabhu, Union Minister for Power. The Minister appreciated the concerns of the Bank, particularly with regard to the servicing of SLR bonds, and said that power sector reforms, which would have long-term implications on the fiscal position of the states, needed to be kept in view. He also appreciated the difficulties of the Bank in regard to its role in operationalising the tripartite agreement with the Government of India and state governments. In a letter dated 31 July 2002, written to R. V. Shahi, Secretary, Ministry of Power, Deputy Governor Reddy reiterated concerns over the tripartite agreement: '[T]he Cabinet should have the opportunity to assess whether faithful implementation of the Agreement could under some circumstances require RBI to give preference to debiting the State Government accounts with expenditures not necessarily approved by the legislature.'

In a meeting held on 26 August 2002, the Secretary, Ministry of Power, discussed the matter with Bank officials. The Secretary said that the Cabinet Committee decision was 'final' and there could be no going back on the treatment of power bonds on the same footing as market borrowing as regards the modality of servicing. Bank officials stuck to the stand that while the bonds would be issued under the Public Debt Act, the servicing of the bonds would be subject to availability of funds in state government accounts. As the issues were rather sensitive, the Finance Secretary was informed of the developments and the Bank's views through a letter by Deputy Governor Vepa Kamesam (28 August 2002). The letter mentioned that as an exception if the Ministry of Finance was agreeable with regard to the treatment of power bonds as SLR securities, the Reserve Bank was prepared to go along with the Ministry on this point. However, the Bank considered the implications of such bonds being managed like any other market borrowings of states as serious and could have far-reaching repercussions in future in case the states were not in a position to meet their obligations.

The Bank suggested two options. First, the government could consider giving a standing authorisation to the Reserve Bank to draw from the government an automatic temporary advance to pay for interest and principal on power bonds. Second, the Ministry of Finance could go back to the Cabinet to seek an amendment to the agreement that the servicing of those bonds would be subject to availability of funds in the state government's account. In its reply, the Finance Ministry advised that the Ministry of Power had agreed that the bonds could be serviced subject to availability of funds in the state accounts, that the bonds would be released in the market subject to specific approvals by the Bank, and that debits to state accounts in respect of current dues could be done on the basis of specific debit instructions issued by the government.

On 12 March 2003, the Ministry of Power, Government of India, informed the Bank that it wanted to have a signing ceremony, to which Deputy Governor Rakesh Mohan wrote (19 March 2003) that the Bank's participation in the signing ceremony was on the understanding that the pending operational and procedural issues would be settled to mutual satisfaction. The agreement was signed on 20 March 2003 in New Delhi and after several deliberations involving the Ministry of Power, Ministry of Finance and the Bank, by August 2003 most of the pending issues relating to the issuance of bonds by the state governments were settled.

Guarantees

An issue that generated considerable discussion was government guarantees to promote investment, mainly in the infrastructure sector. Articles 292 and 293 of the Constitution empower the central and state governments to offer guarantees within limits set by the legislature. Guarantees assumed significance in the early 1990s in the context of participation by the private sector in infrastructure projects. The central government gave guarantees for loans raised by public enterprises, railways, union territories, state governments, local bodies, joint stock companies and cooperative institutions, among others. State governments also provided guarantees in a similar fashion.

While the guarantees did not form part of debt as conventionally defined, in the case of default, they could disturb the fiscal system. Further, guarantees were often given without proper assessment of the projects concerned. The Bank did not manage these contingent liabilities but played an indirect role in sensitising the government to the risk inherent in the guarantees. The Bank also issued guidelines to commercial banks advising them to examine the projects before providing loans to state governments against guarantees.

The issue became quite alarming to the monetary and fiscal authorities, insofar as the state governments were concerned, during the reference period. The demand for extending guarantees for developmental projects was increasing because of a fall in the capital expenditure of states, and their limited borrowing capacity on the one hand juxtaposed with rising demand for basic infrastructure facilities to achieve a higher growth trajectory on the other. In its *Annual Report, 1998–99*, the Bank prophesied: 'Most of the guarantees extended by States are concentrated in favour of financial institutions, which could be discouraging proper risk assessment of credit by such institutions, involving a moral hazard problem.' In 1999, a Technical Committee on State Government Guarantees recommended fixing a limit on guarantees and exercise discretion. The Bank took some steps as a follow-up to the recommendations.

To ensure that the risk profile of guarantees showed, the Bank, in October 1998, advised banks that from 2000–01, investments in state government guaranteed securities outside the MBP would attract a credit risk weight of 20 per cent. Further, in case of default, banks should assign 100 per cent risk weight for investments in such securities. From April 2000, these norms were amended so that the risk weight would apply only to the guaranteed bonds of defaulting entities.

Some states initiated legislation towards placing a statutory limit on guarantees during 1999–2000. Gujarat was the first state to announce such a ceiling on the level of guarantees. Karnataka and Rajasthan also prescribed a cap on total outstanding government guarantees, while states like Tamil Nadu, Bihar and Nagaland were considering the issue of a ceiling on guarantees.

The Bank persevered with its efforts to sensitise state governments about the problems posed by the increasing volumes of guarantees (Table 7.16). With the experience gained thus far, the Bank constituted a Group of State Finance Secretaries to Assess the Fiscal Risk of State Government Guarantees (2002) to suggest a method for the evaluation of the fiscal risk of state government guarantees. The group recommended that guarantees should be met out of budgetary resources and treated as equivalent to the debt; they needed to

Table 7.16 Outstanding Guarantees of State Governments

Year (end-March)	*Amount (₹ billion)*	*Per Cent of GDP*
1997	641.92	4.5
1998	727.82	4.6
1999	793.14	4.4
2000	1,320.29	6.5
2001	1,687.19	7.7
2002	1,648.13	7.0
2003	1,842.94	7.3
2004	2,196.58	7.7
2005	2,042.55	6.3
2006	1,950.49	5.3
2007	1,920.87	4.5
2008	1,843.55	3.7

Source: RBI, *State Finances: A Study of Budgets*, various issues.

be assigned appropriate risk weights, and at least 1 per cent of outstanding guarantees should be transferred to the guarantee redemption fund (GRF) each year, specifically to meet the additional fiscal risk.

As on 30 June 2008, seventeen state governments fixed statutory/administrative ceilings on guarantees, of which eight states set up GRFs. The aggregate outstanding investments in these funds increased from ₹4.30 billion as at the end of March 2004 to ₹28.05 billion as on 31 March 2008.

Other Related Measures

Following the recommendations of the Tenth Finance Commission (1995) and subsequent discussions with state governments, the Bank circulated the scheme of a consolidated sinking fund (CSF) to state governments in June 1999. The objective of setting up a CSF by state governments was to provide a cushion to the repayment of open market loans. As per the scheme, state governments would contribute to the fund every year 1–3 per cent of the outstanding open market loans as at the end of the previous year. A withdrawal was not allowed before five years from the date of notification of the scheme by a state government. The investments in CSF were undertaken by the Bank out of its own stock of government securities.[56]

The Reserve Bank managed the investments in both CSFs and GRFs out of its own portfolio of government securities. The transactions on account of CSFs and GRFs took place at the reference market price released by the FIMMDA. Apart from a small commission, the Bank did not impose any charge on state governments. As of 30 June 2008, twenty states had set up CSFs. The aggregate outstanding investments in CSFs increased from ₹25.84 billion as at the end of March 2004 to ₹202.84 billion as on 31 March 2008.

The Technical Group on Borrowings by States[57] constituted by the Government of India noted that liquidity in state government securities remained negligible in comparison to central government securities. One of the major reasons for this was that the securities were primarily subscribed to by nationalised banks, insurance companies, financial institutions and PDs. Due to the small size of individual stocks, the majority of these investors held these securities until maturity or partly offloaded to RRBs, cooperative banks, provident funds and pension funds. Therefore, reissue of existing security would make the secondary market more active.[58] The matter was discussed in the 19th Conference of State Finance Secretaries on 24 January 2007. State governments agreed to consider issuing two new securities in a financial year. These securities could be reissued for subsequent tranches during the first and second halves of the year.

Conclusion

The chapter outlined the Reserve Bank's role in effecting a transition from a regulated to a market-oriented system of public debt management. The transition had a number of components, including an institutional change in the securities market, the redefinition of the relationship between the government and the Bank, and changes in the processes and procedures within the Bank. Some of these issues are also discussed in other chapters, though their relevance in the context of debt management required a fuller treatment here.

The Reserve Bank played a pivotal role in framing the FRBM Bill (which was subsequently passed as the FRBM Act) and in introducing procedures for a smooth changeover to the new scenario vis-à-vis dealings in the government securities market. The executives of the Bank participated in the regular meetings of the Monitoring Group on Cash and Debt Management convened by the Ministry of Finance to oversee the developments taking place in the domain of government cash flows and in the debt securities markets. The Bank discharged its statutory responsibility of public debt management, in coordination with the government, through policy formulation and evolving operational procedures in response to the emerging situation in the securities market. The Bank took the initiative in exploring the possibility of 'active' consolidation of a portfolio of government dated securities through debt market operations. Equally significant, the need for separation of debt management from monetary management responsibilities was strongly mooted by the Bank. This concept found favour with the government. However, for reasons already cited earlier in this chapter as well as in Chapter 3, progress in this direction was modest.

A particularly far-reaching transformation occurred in the sphere of public debt management of states. There is no better way to sum up the nature of the change than to refer to a speech that Governor Reddy delivered at the Madras School of Economics on 23 September 2007. In the Indian polity, Governor reminded the audience, the states had taken a prominent place in the reform process because areas of national priority, such as agriculture, education and public health, fell within the purview of states. There was, however, little literature available on the theory or practice of the role of central banks in dealing with sub-national governments, which made the Bank's experience particularly valuable. The collaborative process started with the Annual Conference of State Finance Secretaries in November 1997, which founded the collaboration on dialogue, consultation and 'mutual trust'. In the process, the Bank continuously adapted its WMA strategy and proposals on investment of cash balances. The Bank provided comprehensive technical inputs to the Government of India for formulating and enacting the FRBM Act by Parliament, which paved the way for a model fiscal responsibility legislation for states.

Notes

1. Jammu and Kashmir had such agreements in the period of the study.
2. In the government securities market, a policy of passive consolidation through reissuance of securities was started in 1999 to improve fungibility among the securities and to facilitate consolidation of debt. The larger size of securities was intended to improve market liquidity and help in emergence of benchmark securities in the market.
3. See Reserve Bank of India, *The Reserve Bank of India, Vol. 4: 1981–1997* (New Delhi: Academic Foundation, 2013) on the process leading to this step. Also see Chapter 3.
4. For example, the RBI *Annual Report, 1998–99*, expressed the fear that the revenue deficit of the centre and states placed enormous burden on the capital account of the budgets, and were not sustainable even if India's real gross domestic product (GDP) grew at an average of 6–6.5 per cent per annum. Similar concerns were raised again in the next year's annual report. The report added that in the interest of sustainability, a strong institutional mechanism in the form of fiscal responsibility legislation (FRL), as announced in the preceding Budget, would be necessary. The FRL would aid sustainability, but for it to be credible, the law should include stringent requirements for fiscal transparency, backed by strong enforcement mechanisms. Following a technical paper published in the *RBI Bulletin* (December 1997), a discussion followed on the theoretical and practical rationale for fixing a statutory limit on public debt. A statutory limit, apart from keeping the size of debt manageable, would enhance the credibility of anti-inflationary policy and make the domestic economy more efficient in terms of resources use. International experiences showed that many countries placed limits on the government's access to central bank credit. The European Union countries

had two separate limits for government borrowings, one based on flow of debt in a year and another based on the debt stock at the end of every financial year.

5. In early 2000, the Bank conducted a seminar, in which senior officials of the centre and states participated, on matters relating to fiscal rules and international practices.
6. An extract from the speech of Governor Y. V. Reddy, made at the National Institute of Public Finance and Policy (NIPFP) on 26 May 2008.
7. Other members included then Deputy Governor Reddy; Controller General of Accounts A. M. Sehgal; J. S. Mathur, Additional Secretary (Budget and Coordination), Department of Economic Affairs; Ashok Lahiri, Director, NIPFP; N. L. Mitra, Director, National School of Law; and a nominee of the Comptroller and Auditor General of India.
8. Prem Chand of the International Monetary Fund (IMF), at the invitation of the Reserve Bank, spent some time advising the working group on international best practice.
9. The government set up a Task Force on Implementation of the FRBM Act, 2003 (Chairman: Vijay Kelkar). The report of the Task Force was submitted on 16 July 2003. It addressed the issue of fiscal planning in two stages, provided baseline projections on central government finances and devised policy proposals which closed the gaps, if any, between the baseline projections and the requirements of the Act.
10. Saumitra Chaudhuri later became a member of the Prime Minister's Economic Advisory Council.
11. Willem H. Buiter and Urjit R. Patel, 'Fiscal Rules in India: Are They Effective?' NBER Working Paper Series, Cambridge MA, 2010.
12. Ricardo Hausmann and Catriona Purfield, 'Challenge of Fiscal Adjustment in a Democracy: The Case of India', NIPFP/IMF Conference on Fiscal Policy in India, 16–17 January 2004, New Delhi.
13. Along with other measures to facilitate market participation in borrowing programmes, the settlement system for transactions in government securities was standardised to T + 1 cycle from 24 May 2005. The aim was to provide the participants with more processing time at their disposal, thereby enabling better management of both the funds and the risks. To provide the members of the Negotiated Dealing System (NDS) with a more efficient trading platform in government securities, the NDS-Order Matching (NDS-OM) trading module was introduced from 1 August 2005. Intra-day short-sale was permitted in government dated securities, subject to certain stipulations from 28 February 2006. Guidelines for introduction of 'when-issued' market in central government securities were issued on 3 May 2006. 'When-issued' is a conditional transaction in a security authorised for issuance but not yet actually issued. This type of market facilitated stretching the actual distribution period for each issue and allowed the market more time to absorb

large issues without disruption and thus helped in price discovery. 'When-issued' trading commenced from 1 August 2006 with respect to two securities auctioned on 8 August 2006.

14. In countries with well-developed financial markets, debt management is based on the fiscal operations of the government while monetary policy is carried out independently. However, achieving a separation between debt management and monetary policy might be more difficult in countries with less-developed financial markets, since debt management operations in that case can have significant effects on interest rates and local capital markets.
15. Chairman: S. S. Tarapore, 1997.
16. The Bank set up a working group (Convenor: V. Subrahmanyam, 1997) against the backdrop of transfer of debt management from the Bank of England to the Treasury in the United Kingdom from July 1997.
17. The Advisory Group on Transparency in Monetary and Financial Policies (Chairman: M. Narasimham, 2000) also recommended separating debt management and monetary policy functions.
18. The group noted that different models of DMOs were available and in many countries, such as Denmark, debt management function continued to be performed by the central bank.
19. The meeting also discussed division of responsibilities and concluded that the Bank would continue to handle borrowings under the MSS and actual implementation of the borrowing programme.
20. There was a steep rise in the requirement of government securities due to sterilisation of foreign exchange inflows in 2003–04. In a letter to the Secretary (Expenditure and Budget) dated 26 March 2004, Deputy Governor Rakesh Mohan pointed out that the surplus balance in the Government of India's cash account being very high in the previous two weeks, the Bank risked running out of securities for delivery under the LAF (see Appendix 7A.2). To avoid having to reject repo bids, the Bank suggested placing a ceiling on the amount of surplus balance of the government that could be invested. In other words, any balance eligible for investment more than the ceiling would not earn any interest. The letter added that the ceiling might be revised downwards depending on the availability of securities, consequent on the increasing size of the monetary operations in the future.
21. It could send feelers to the market that, henceforth, the government might not issue many short-dated securities in view of the implications of growing borrowing requirements. There was a trade-off between paying marginally more for current borrowing requirements by borrowing longer term and paying substantially more in future.
22. The FRBs were issued in 1995 when the interest rates were very high, and on the assumption that the rates would fall. The coupon on the FRB was linked to average cut-off yields in 364-day Auction T-bills. These were at that

time auctioned without a notified amount and the rates that emerged at the auctions were not taken by the market as truly market determined, with the Bank deciding the cut-off.

23. With the Discount and Finance House of India, Securities Trading Corporation, SBI and Punjab National Bank.
24. With a view to moderating the impact of large borrowing programmes, the Bank on occasions accepted private placement of government stocks and released them to market when interest rate expectations turned favourable and liquidity conditions improved. The Bank offloaded its initial subscriptions when it needed to through net open market sales. This practice came to an end in April 2006.
25. A 'held-to-maturity' security is purchased with the intention of holding the investment to maturity, a decision that is based on the view that in the long run, financial markets give a good rate of return even while taking into account a degree of volatility. The opposite of buy-and-hold is active trading, in which an individual tries to be short on the peaks and buy on the lows, with more money coming forth with more volatility.
26. Letter from Deputy Governor Mohan to Finance Secretary S. Narayan.
27. The letter to the government by Deputy Governor Mohan considered the proposal.
28. Active consolidation involved a net premium payable by the government since most of the illiquid securities were high coupon, whereas the securities reissued would be largely current coupon. It would also involve a trade-off between increased interest rate risks of banks and other investors and higher rollover risk for the government. Operationally, buyback would mean additional borrowing by the government, though the net increase in debt would be limited to the extent of net premium payable.
29. To quote,

    > most of the illiquid securities are likely to be held by banks in their HTM category.... To the extent this is done, the objective of consolidation exercise will be defeated since HTM securities are virtually out of the pale of trading; and a large number of illiquid securities are held by LIC.... LIC might have a natural reason to hold high coupon securities if it follows a policy of matching liabilities with assets. If this is so, LIC may not like to sell these high coupon securities. Thus, tradability might actually not improve.

    IDMC (Internal Debt Management Cell) was renamed as IDMD (Internal Debt Management Department) in May 2003.
30. A liaison group constituted by the Ministry of Finance, which included representatives from the Bank, met on 9 September 2005 and 24 May 2006, and worked out a firm proposal for implementing the scheme. The proposals

included an auction to buy back the selected securities and, depending upon the response in the auction, to decide whether to go for further rounds of auctions or follow up the auction with bilateral deals with investors and PDs. These recommendations were conveyed to the Ministry of Finance (letter dated 18 July 2006 from Chief General Manager, IDMD). In November 2006, a new draft scheme was prepared by the IDMD under the guidance of Deputy Governor Mohan. The scheme envisaged that the entire consolidation exercise (buyback as well as replacement issues) was to be done in the books of the government and exclusively funded by the government without affecting the Bank.

31. Letter dated 18 December 2006 from L. M. Vas, Joint Secretary.
32. Some of the important suggestions were that the objectives should include smoothening of the maturity profile of debt, and the option of payment for the bought back securities, different methods of issuance such as auctions, switches or bilateral operations were to be highlighted, and a change be made such that buyback operations would normally precede the replacement issues, except in the case of switches.
33. The group was chaired by the Additional Secretary (Budget), Government of India, and the members included the Controller General of Accounts, the Economic Adviser and the Executive Director (RBI) dealing with IDMC, among others.
34. Written by the Executive Director, Khizer Ahmed, to the Finance Secretaries of Assam, Bihar, Uttar Pradesh and Arunachal Pradesh – states which had not completed their annual MBPs by December 1999.
35. Office note dated 28 March 2001.
36. The ten-year yield (liquid paper) was around 7.78 per cent. It was noted that the market participants had been asking for a higher spread for state government paper. In his note seeking the approval of the Governor, Deputy Governor Reddy observed that the effective spread for state governments over the centre's paper came to 44 bps. In view of the low yields for the centre's paper and market perceptions of states' papers, a large premium seemed inevitable.
37. For example, on 27 May 2005, the Finance Secretary of Kerala informed the Deputy Governor that because of the improved fiscal position of the state, it had swapped some loans due to the Government of India and the outstanding loans with the General Insurance Corporation (GIC), with own resources. LIC had agreed to the prepayment with respect to their outstanding loans. But the premium being substantial, the state requested the Bank to support its proposal for an open market borrowing to fund this expenditure. On 9 June 2005, the Commissioner and Secretary to Assam advised the Bank that the Assam government had constituted a Consolidated Sinking Fund (CSF) for redeeming its open market loan. He requested that the bidders in the

forthcoming auction issue may be informed of this so that they felt more comfortable with the bonds.

38. The 16th Conference of State Finance Secretaries (8 April 2005) stressed the need for a coordinated and smooth transition to a market-based system. Subsequently, in July 2005, the government constituted a technical group (chaired by Deputy Governor Shyamala Gopinath) to work out the mechanism of a transition. Based on the recommendations of the group, the Bank's Annual Policy Statement for 2006–07 proposed to form a standing technical committee under the aegis of the Conference of State Finance Secretaries with representation from the central and state governments and the Reserve Bank to advise on wide-ranging issues relating to the borrowing programme of the central and state governments through a consensual and cooperative approach.
39. For states, the DSS was debt-neutral as it involved swapping one form of debt with another. In states' budgets, repayment of loans to the centre reduced the debt of states. However, as this repayment was made out of additional market borrowings and small saving transfers, it increased the debt from these sources by an equal magnitude. Over a period of time, however, savings in the form of lower interest payments reduced the pressure on the revenue account of states and thereby reduced their borrowing requirement.
40. One such occasion arose in March 2000, when the Ministry of Finance advised the Bank to arrange additional market borrowings of ₹14.20 billion for six state governments. The Bank suggested that the government adjust the allocation against the current budget (1999–2000) and then get it readjusted in 2000–01. But the government wanted the money to be raised urgently. Deputy Governor Reddy desired that the issues arising out of the proposal be examined by the IDMC. The IDMC held (office note of 9 March 2000) that if state governments entered the market at that point in time, there would be problems of fixation of coupon as the yield for a ten-year coupon in the primary market then was quite volatile. The secondary market rate of a similar maturity had also varied widely. Moreover, since both the central and state governments would enter the market in April 2000, it would not be appropriate to enter the market in March. The note suggested that the quantum of additional borrowing could be taken as private placement with the Bank. The amount would be raised by the government as part of its MBP with a maturity period of ten years, and subsequently passed on to state governments as loans. This type of transaction, the office note felt, carried no adverse implication on the fiscal deficit as the amount raised would be shown in both the capital receipts and capital expenditure. Governor Jalan, after discussions with Reddy, instructed (on 13 March 2000) the office to go ahead with state loans. The matter, however, was raised in subsequent correspondence between the Bank and the Ministry.

41. The adverse effect was obvious for state governments. The Bank would not be affected as a debt manager, but it could face some challenges in trying to boost the confidence of the market.
42. The Secretary, Department of Expenditure, Ministry of Finance (C. S. Rao), 'fully endorsed' the Bank's concerns, and agreed, with specific reference to West Bengal, that the debt profile was becoming 'increasingly unsustainable' (16 November 2001).
43. 'Special Category' refers to states considered by the Planning Commission and the National Development Council as either historically disadvantaged (difficult terrain, low population density, large tribal population) or strategically important (located on an international border) for allocation of central plan assistance.
44. This perception was conveyed to the government in Deputy Governor Reddy's letter dated 7 January 2002 to Secretary C. M. Vasudev.
45. The progressive reductions in the Bank Rate had brought the interest rates on WMA and overdrafts to 9 per cent and 11 per cent, respectively. However, when the Bank Rate was raised from 9 per cent to 11 per cent on 16 January 1998, the interest rates with respect to WMA and overdrafts of state were maintained at 9 per cent 11 per cent, respectively.
46. The Informal Advisory Committee on Ways and Means Advances to State Governments (Chairman: B. P. R. Vithal).
47. A lower and uniform margin of 5 per cent (compared to 10 to 15 per cent margin earlier) would be applied on the market value of the securities for determining the operating limit of special WMA. States would have to make use of special WMA limits at a rate of 1 per cent below the Bank Rate, before seeking accommodation under the normal WMA limits. The number of days a state could be in overdraft was extended to fourteen consecutive working days.
48. Chairman: M. P. Bezbaruah.
49. The aggregate normal WMA limit was increased for 2006–07. The interest rate on WMA was linked to the LAF repo rate (against the Bank Rate earlier) as it was more reflective of short-term monetary conditions. The rate of interest on overdraft would be 2 percentage points above the repo rate (the existing level was 3 percentage points above the Bank Rate) for overdraft of 100 per cent of normal WMA limit, and 5 percentage points above the repo rate (against the existing 6 percentage points above the Bank Rate) for overdraft exceeding 100 per cent of the normal WMA limit. The revenue deficit, wherever applicable, was to be excluded from the base. With the objective of providing an incentive to state governments to build up the consolidated sinking fund (CSF) and the guarantee redemption fund (GRF), net incremental annual investments in these funds were made

eligible for making use of special WMA up to a ceiling equivalent to the normal WMA limit.

50. The working group report (December 2006) recommended reduction of non-compulsive borrowings (such as open market borrowings, negotiated loans and loans relating to externally aided projects), enhancement of contributions to CSF/GRF and discharge of overdue guaranteed obligations, buyback of securities (open market loans, power bonds with embedded call option, and so on), investment in securities other than T-bills, placing the funds in public accounts in a trust set up by state governments outside their Budgets or make financial investments in enterprises owned by them, linking the discount rate on ITBs to the reverse repo rate, and formation of specialised debt and investment management units (DIMUs) in state governments.
51. Major states were Uttar Pradesh, Tamil Nadu, Assam, Bihar and Madhya Pradesh.
52. These meetings became an effective platform for all stakeholders – states, the centre and the Bank – to discuss transitional issues and form partnership.
53. The draft report of the group was discussed at the 14th Conference of State Finance Secretaries in August 2004 and the final report was submitted to the Bank in January 2005. It was intended to provide guidance to states for enacting their fiscal responsibility legislation regarding certain benchmarks.
54. Chairman: M. S. Ahluwalia, 2001.
55. Conveyed by Deputy Governor Reddy to the Finance Secretary, Ajit Kumar, on 29 March 2001.
56. The scheme was revised in line with the recommendations of the Twelfth Finance Commission (TFC, November 2004), the Advisory Committee on Ways and Means Advances to State Governments (Chairman: M. P. Bezbaruah, October 2005) and the Technical Group on Borrowings by the States (Chairperson: Shyamala Gopinath, December 2005). The revisions included extending the ambit of the CSF to cover amortisation of all liabilities (and not just open market borrowings); making states eligible to make use of special WMA equivalent to their net incremental annual investment in CSF; making states contribute at least 0.5 per cent of the outstanding liabilities to the fund; and allowing provision for acquiring of securities by the Bank from the secondary market. In May 2006, the revised scheme was circulated to state governments.
57. Chairperson: Deputy Governor Shyamala Gopinath.
58. If a security is reissued, the terms and conditions in respect of coupon payment and maturity remain unchanged. The increase in lot size through reissuance of the security would improve liquidity but would result in bunching of repayments. As a result, it was pointed out that states would have to make bullet payment of a larger size at the time of maturity of the security, which, in turn, would increase the refinance risk.