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Public Debt Management

INTRODUCTION

The size and method of financing the Government's budgetary deficit have an important bearing on prudential macroeconomic management, in general, and monetary management, in particular. This is because fiscal imbalances in the long run engender serious consequences for macroeconomic stability, which became strikingly evident in the events leading to the balance of payments (BoP) crisis in India in 1991. All along, the Reserve Bank, which has been entrusted under its statute¹ with the internal debt management of the Government, has been co-ordinating closely with the Ministry of Finance in formulating and implementing the latter's annual market borrowing programme, appraising the Central Government from time to time of its concerns over the building up of unsustainable fiscal imbalances and monetisation of budget deficits *via* the Reserve Bank accommodation and other related developments as well as issues impacting on internal public debt management. These features of the pre-crisis period have been brought out succinctly in the chapter, Monetary-Fiscal Interface, which covers the developments from 1981–82 to 1988–89.²

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1. In terms of section 21 of the Reserve Bank of India (RBI) Act, 1934, the Reserve Bank is vested with the responsibility of the management of the public debt and issue of new loans of the central government and that of the state governments by virtue of agreements entered into with them under section 21A.
 2. Reverting to the 1980s, the Reserve Bank's role was basically one of debt manager to the central government (as also to the state governments). Moreover, the internal debt management policy followed was a passive one due to various reasons. More important

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PASSIVE TO ACTIVE DEBT MANAGEMENT

The financial system until the 1980s was devoid of market orientation and was subjected to tight regulations relating mainly to portfolio choices by institutions, instruments and their pricing. The policy was to offer low coupon rates on government securities in order to keep government borrowing costs down. More or less the same situation prevailed till the 1990s in respect of the bond market as well. In this restrictive environment, the fundamental debt management functions discharged by the Reserve Bank in the capacity of agent of the Government remained passive and monotonous, with the Government's demand for borrowed funds being met from a captive group of investors. The Reserve Bank was a participant in absorbing the marketed debt not subscribed by others and the supply was at non-market-related interest rates, which at times translated into negative real rates of return. Consequently, money and government securities markets hardly gained vibrancy. The Reserve Bank's monetary management was also constrained by the practice of automatic monetisation of government budget deficits at a fixed and below the market rate of 4.6 per cent in the form of placement of *ad hoc* 91-day Treasury Bills, which had been in vogue since the mid-1950s.

The adoption of an active internal debt management policy assumed significance from the early 1990s with the launch of the financial sector reforms that ushered in a market-oriented system. This new direction also opened more vistas for monetary management. However, the impetus for the reform had been provided much earlier by the report of the committee to review the working of the monetary system (Chairman: Prof Sukhamoy Chakravarty)³ which strongly recommended that the borrowing requirements of the Government should be financed from the open market by evolving a market-clearing interest rate mechanism. This was expected to reduce the extent of debt monetisation. The actual thrust

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of these were, the absence of any definite limit on excessive automatic monetisation of the Central Government's fiscal deficit, low coupon rates offered on government securities and the gilt-edged market being dominated by institutional investors, who were required to mandatorily invest a portion of their resources in government and other approved securities. All these circumstances severely inhibited the development of a secondary market in the government securities and thereby the conduct of active open market operations by the Reserve Bank. More importantly, in such a milieu, the effectiveness of monetary and credit policy became attenuated. These, among others, form the subject matter of the previous link chapter 3: Monetary-Fiscal Interface.

3. Refer to Appendix 4.1.

for activating the government bond market in the reform era came from the report of the committee on the financial system (Chairman: Shri M. Narasimham). These developments have been covered subsequently in this chapter.

The debt management function was traditionally performed by the Secretary's Department in the Reserve Bank since its inception. With a view to strengthening internal debt management, evolving policy options and issuing guidelines for trading in government securities, the Reserve Bank set up an Internal Debt Management Cell (IDMC) within the Secretary's Department in April 1992. This was carved into a distinct entity in October 1992. Initiating the steps for the formation of the cell, the Governor, Shri S. Venkitaramanan, envisioned that it would attend exclusively to internal debt management and operations, consisting of open market operations (OMOs), market borrowings, state governments' ways and means advances (WMA) and related matters. It devoted attention to evolving an active role in internal debt management operations, devising new policy instruments and shoring up delivery capabilities to facilitate the development of a dynamic and efficient government securities market.⁴

The Reserve Bank, in co-ordination with the Central Government, initiated several reforms in quick succession in the government securities market from 1992 to 1997. The reform process comprised active policymaking, strengthening of the institutional infrastructure, setting-up of dedicated clearing and settlement systems, expansion of trading, diversification of market participants and instruments, consolidation of a transparent regulatory system, implementation of state-of-the-art technology and enactment of enabling market-related legislation, rules and procedures.⁵ Special mention may be made of the introduction of auction-based sale of 91-day Treasury Bills and auctions for dated government securities. The market practically had to be groomed and nurtured during this period by having dialogues with treasury managers, periodic meetings and workshops. These paved the way for the development of government bond market that enabled the Reserve Bank to progressively move away from direct instruments, namely, cash reserve ratio (CRR) and refinancing facilities, to indirect market-based instruments like OMOs, interest rates and other liquidity management techniques, including the repos. In consonance with this path-breaking policy shift, reserve requirements

4. The IDMC was converted into a full-fledged department in May, 2003.

5. A reference may be made to Annex I to this chapter.

were scaled down in a calibrated manner. Greater reliance was placed on evolving an integrated and active internal debt management policy. In this regard, a far-reaching event was a gradual increase in the interest rates of government securities to a level closer to market-determined rates and also a lowering of their maturity profile.

The long-term objective was to facilitate the emergence of a market-based yield curve. Since the secondary market was slow to develop in the initial stages, the term structure of primary market yields through auctions served as the yield curve. State government loans were floated first during a financial year that set the 10-year benchmark and auction-based central government debt during the rest of the year set the primary yield curve. Later, with the secondary market yield gradually emerging, the primary yield curve was adjusted taking into account the secondary market trades, before the secondary market acquired the necessary depth and was able to eventually provide a genuine market-based yield curve.

Perhaps the most defining event in public debt management was the phasing out of automatic monetisation of the budget deficit (the first supplemental agreement of September 1994) and the discontinuation of *ad hoc* Treasury Bills (the second supplemental agreement of March 1997). This imparted an element of discipline in budgetary finances and strengthened the effectiveness of monetary policy. The manoeuvrability of the Reserve Bank in managing the public debt consistent with its monetary policy got a boost with these supplemental agreements with the Government. The overdraft regulation scheme in operation since the mid-1980s in the case of the state governments served, in a way, as a model for related practices for the Central Government, though stoppage of payments by the Reserve Bank for the Central Government was not envisaged for practical reasons.

CHAPTER OUTLINE

Under a long-standing arrangement, the Reserve Bank and the Ministry of Finance conduct an annual dialogue on the monetary projections and the overall market borrowing programme of the Central Government, state governments and government-guaranteed institutions as part of the exercise for preparation of the Union Budget for the ensuing financial year. Against this backdrop, the section that follows flags various policy matters that were suggested by the Reserve Bank in the correspondence exchanged from time to time. Besides, there were other important topics and events

that occupied the centre stage during this period, which are narrated in the following order:

- (i) Discontinuation of the issue of *ad hoc* Treasury Bills in a phased manner, which paved the way for the Central Government to meet its borrowings through market-based instruments.
- (ii) Major developments in the Reserve Bank's internal debt management policy and operations with special reference to instruments and institutional growth.
- (iii) Progress in fiscal consolidation and the Reserve Bank's interest in organising its debt management and monetary management functions in a co-ordinated and integrated manner.
- (iv) Significant developments in the government securities market which strengthened and supported internal debt management policies and operations.
- (v) An insight into policymaking aspects on select issues, *viz.*, consolidated sinking fund (CSF), sovereign bond issue, and foreign institutional investors' (FIIs) investments in government securities.
- (vi) Special features of the borrowing programme of the state governments.
- (vii) Concluding observations.

FORMULATION OF ANNUAL MARKET BORROWING PROGRAMME

Every year, either in December or at the beginning of January, the Reserve Bank and the Ministry of Finance engage in consultations (in the form of letters and personal discussions) on the monetary projections and the Government's market borrowing programme for the coming fiscal year to arrive at an acceptable level of budget deficit and determine the stance of fiscal and monetary policies to be pursued during the year. This process of co-ordination and exchange of views enables formulation of integrated and mutually supportive monetary and debt management policies. Besides, this dialogue helps the Reserve Bank firm up a number of macroeconomic projections for the following year on a consistent basis. More significantly, after the adoption of financial sector reforms in 1991–92, it provided the Reserve Bank with the opportunity to apprise the Government of its views and suggestions on a wide range of topics concerning internal debt management strategies, such as, strengthening the government securities market, coupon rates, maturity pattern of dated securities, introduction

of long-dated Treasury Bills on auction basis, funding of Treasury Bills and automatic monetisation of budget deficit through the issue of *ad hoc* Treasury Bills. Policy issues relating to internal debt management closely linked with monetary and credit policy, also gained importance.

The keynote of each year's projected borrowing programme varied in both content and emphasis depending on the behaviour of the macroeconomic fundamentals and economic policy priorities, *viz.*, restraining pressure on prices and reducing the budget deficit (1990–91 and 1991–92); activating the internal debt management policy and modernising the financial sector (1992–93); reducing gross fiscal deficit (GFD) and controlling strong liquidity growth emanating from inflow of foreign capital (1993–94); phased elimination of automatic monetisation of budget deficit (1994–95); and follow-up measures consequent to the abolition of *ad hoc* Treasury Bills to bridge the budget deficit (1996–97).

Except for the years 1993–94, 1995–96 and 1996–97, the actual borrowings (net) were lower than the borrowings projected by the Reserve Bank (Table 15.1). However, this hypothesis is only of academic interest because soon after the Reserve Bank communicates its market borrowing projections to the Government for the ensuing year, the Governor of the Reserve Bank invariably follows this up with discussions with the officials of the finance ministry as part of the overall budget formulation exercise. At this meeting, the estimated budget deficit, RBI credit to the Government and the quantum of market borrowing by the Centre and states during the ensuing year are firmed up after discussions for inclusion in the Union Budget. In other words, in every probability, the preliminary figures forecasted by the Reserve Bank for market borrowing (in its letter) undergo revision as an outcome of the pre-budget confabulations.⁶

MARKET BORROWING PROGRAMME FOR 1989–90

Concerns Over Emerging Macroeconomic Trends

The letter dated January 7, 1989 from the Governor to the Finance Secretary conveyed the perceptions of the Reserve Bank stemming from the monetary exercise for the year 1989–90, which were symptomatic of a deepening crisis.

6. In terms of a long-established practice, after the regular Budget is presented in Parliament (by convention, in the last week of February), the Union Finance Minister addresses the meeting of the Directors of the Central Board of the Reserve Bank of India, which is mostly convened in New Delhi.

TABLE 15.1
*Market Borrowings of the Central and State Governments:
 Projections and Actuals*

	(₹ crore)			
	1989-90	1990-91	1991-92	1992-93
Overall Market Borrowing Programme as projected by RBI	12,200	12,925	14,125	12,000
Market Borrowing (Gross)	10,599	11,558	12,284	17,690
Market Borrowing (Net)	9,654	10,570	10,865	11,932
Excess over projected estimate	-2,546	-2,355	-3,260	-68
	1993-94	1994-95	1995-96	1996-97
Overall Market Borrowing Programme as projected by RBI	7,500	33,030 [@]	30,150 [#]	31,300
Market Borrowing (Gross)	54,533	43,231	46,783	42,688
Market Borrowing (Net)	32,164	25,197	32,721	32,892
Excess over projected estimate	24,664	-7,833	2,571	1,592

Notes: @: The earlier RBI estimate was ₹ 9,650 crore in dated securities and ₹ 10,000 crore in 91/364-day Treasury Bills.

#: The earlier RBI recommendation was ₹ 23,700 crore.

Table 15.1 represents the market borrowings of the central and state governments, local authorities and institutions sponsored by central and state governments.

Source: Reserve Bank of India, *Annual Report, Report on Currency and Finance*, various issues.

The Reserve Bank had earlier agreed on a target of M_3 growth in 1988-89 of 16.3 per cent, taking into consideration the overhang of primary liquidity. But the M_3 increase in 1988-89 (up to December 16, 1988) had touched 11.8 per cent and the annual overall increase was expected to be at the targeted level. Meanwhile, the Reserve Bank was concerned that the net Bank credit to the Central Government had already increased by ₹ 9,065 crore as against ₹ 6,628 crore in the previous year and the indications were that even the budget document figure of ₹ 7,484 crore could well be breached. Additionally, policymakers in the Reserve Bank had to contend with the fact that the overhang of reserve money creation in the past had still to work itself out. The rate of growth in the economy in 1989-90 even under the most favourable circumstances was not expected to be higher than 5.0 per cent and it was recognised that measures would have to be initiated to moderate the rate of inflation. Given this bleak scenario, the Reserve Bank opted for M_3 expansion target of 15.0 per cent in 1989-90.

In order to contain the M_3 expansion at 15.0 per cent, the Reserve Bank posited that it would be desirable to limit the increase in net Bank credit to the Central Government in 1989–90 to ₹ 8,200 crore, of which the budgetary deficit was to be ₹ 7,000 crore (as compared with the budgeted amount of ₹ 7,484 crore in 1988–89) and the balance ₹ 1,200 crore was to be bridged by way of Reserve Bank support to the borrowing programme. Within these overall parameters, the Reserve Bank suggested that the total market borrowing programme should not exceed ₹ 12,200 crore, *i.e.*, ₹ 479 crore more than the limit for the previous year. The Bank indicated:

... would recommend that once the allocations are agreed to at the start of the year ad hoc increases should not be made during the course of the year. This policy has worked well so far in 1988–89 and ... would strongly advocate its continuation next year.

MARKET BORROWING PROGRAMME FOR 1990–91

Primacy for Inflation Control

Taking into account primarily the prevailing and emerging trends in national income growth and broad money/money supply (M_3) expansion in 1990–91, bank deposits and non-food credit, the Governor, Shri R.N. Malhotra, in his letter dated February 8, 1990 to the finance ministry, postulated that the overall market borrowing programme for the Central Government in 1990–91 could be ₹ 12,925 crore, of which the share of the Centre was ₹ 7,400 crore. Further, given the trends in money supply growth and inflationary pressures and the need to contain monetised deficit, the Reserve Bank advised that it did not propose to provide support to the market borrowing programme in 1990–91 and as such the entire 'permissible' increase in the Reserve Bank credit to the Government should be shown as budget deficit. The Governor added that the overall budget deficit could be progressively reduced to zero and the longer-term resource needs of the Government met through a mutually agreed WMA from the Reserve Bank and Treasury Bills raised from the market by 1993–94. Thus, the seeds for discontinuing the automatic monetisation of budget deficit were sown in the early 1990s, but it became a reality much later in 1997–98, after the financial markets became vibrant with the launching of the financial sector reforms.

The Centre's gross market borrowings of ₹ 8,989 crore comprised cash subscriptions of ₹ 8,531 crore and conversion of maturing loans

₹ 458 crore. In respect of the state governments, there were no maturing loans in 1990–91. The Reserve Bank's initial subscription to central government loans during 1990–91 formed 49.3 per cent of the total loans floated, as compared with its initial subscription of 60.4 per cent of the total in the previous year. During the year, the Central Government issued to the Reserve Bank special securities worth ₹ 30,220 crore, of which ₹ 30,000 crore were towards funding *ad hoc* Treasury Bills. The funding of *ad hoc* Treasury Bills was last undertaken in 1987–88 for ₹ 17,500 crore.

MARKET BORROWING PROGRAMME FOR 1991–92

Emphasis on Moderating the Central Government's Budget Deficit

Consistent with the expected growth in bank deposits and non-food credit, the Reserve Bank predicated that the increase in net RBI credit to the Central Government should not exceed ₹ 8,000 crore. On this analogy, the Centre's budget deficit in 1991–92 was placed at 1.4 per cent of gross domestic product (GDP) at current market prices. The overall market borrowing in 1991–92 was fixed at ₹ 14,125 crore. In his letter dated January 8, 1991, the Governor, Shri S. Venkitaramanan, stressed that statutory liquidity ratio (SLR) had been increasing sharply in 1990–91; with an unchanged SLR in 1991–92, there was 'no way' in which the overall market borrowing in 1991–92 could be higher than that in the previous year; the Reserve Bank would not provide any support to the market borrowing programme; and the entire increase in net RBI credit to the Central Government should be indicated as budget deficit in the documents.

The letter also conveyed the Reserve Bank's perceptions on major policy issues relating to public debt management and sought the Government's agreement for initiating measures to activate the government securities market as well as internal debt management. It was pointed out that in immediate past, the government borrowings other than under the market borrowing programme had been increasing rapidly and the effective cost of such borrowing, taking into account the fiscal concessions, worked out substantially higher than the costs incurred under the annual market borrowing programme. The Reserve Bank made a strong case for applying market-related interest rates on government securities, which would reduce the monetisation of the deficit and, ultimately, result in a decline in nominal interest rates, *viz.*:

Extremely high reserve requirements and below market rates of interest on the Government's marketable debt, far from improving the resource allocation, cause avoidable distortions. This also results in the monetisation of a large part of the Government borrowing. It is often argued that higher interest rates on Government securities could raise the cost of servicing the Government's internal debt. It needs to be recognised that market-related rates on Government securities would widen the demand for these securities thereby reducing the monetisation of the deficit. Eventually, as inflation comes under control there would be a reduction in the cost of borrowing as nominal interest rates would decline.

Further, a number of policy prescriptions were proffered, such as removing the cap on interest rate on 182-day Treasury Bills, the introduction of longer maturity Treasury Bills, increase in the discount rate on 91-day Treasury Bills and an increase in the rate of commission on state government flotations. What is important to note is that both the Reserve Bank and the Government acted in close understanding and rapport to activate internal debt management strategy as an adjunct to fiscal consolidation and more effective monetary management.

The net market borrowings by the Central Government were placed at ₹ 7,501 crore as against ₹ 8,001 crore in 1990–91; this reflected the results of the concerted efforts to reduce the reliance on market borrowing for financing government expenditure. The Reserve Bank's initial subscription to the 1991–92 central government loans, however, was 54.1 per cent of the gross market borrowings as against 49.3 per cent in the previous year. The Central Government issued special securities to the Reserve Bank against funding of *ad hoc* Treasury Bills to the tune of ₹ 5,000 crore during 1991–92.

MARKET BORROWING PROGRAMME FOR 1992–93

Focus on Implementation of Financial Sector Reforms

The strong inflationary potential in the economy and the on-going financial sector reforms called for major policy adjustments in directed credit and downward revision in the existing statutory reserve prescriptions, based on the recommendations of the Narasimham Committee.

The Reserve Bank's perceptions and suggestions relating to the market borrowing programme for 1992–93 were influenced by the

recommendations of the above committee and the need to nip in the bud the strong inflationary potential. In his letter dated January 2, 1992 to the Secretary, Economic Affairs, Ministry of Finance, the Governor cited the following facts: the Centre's budget deficit in 1991-92 even by the third quarter of the year (*i.e.*, up to December 13, 1991) was as high as ₹ 17,419 crore as against ₹ 7,719 crore (BE) for the full financial year 1991-92; adherence to the tentative numbers agreed to with the International Monetary Fund (IMF) for 1992-93 (*viz.*, net RBI credit to Central Government of ₹ 6,200 crore and M_3 expansion of 11.0-12.0 per cent); the budget deficit and the market borrowing programme to be in conformity with the Government's primary objective of reducing the GFD from 6.5 per cent of GDP in 1991-92 to 5.0 per cent in 1992-93; and the overall market borrowing programme for 1992-93 to take into account the recommendations of the Narasimham Committee for a decrease in SLR on incremental domestic deposit liabilities, from 38.5 per cent to 30.0 per cent. Moreover, the Reserve Bank recommended that M_3 growth in 1992-93 needed to be contained within 12.0 per cent and the budgetary deficit of the Centre (*i.e.*, net RBI credit to the Central Government), not to exceed ₹ 6,200 crore during that year. Accordingly, the overall market borrowing programme for 1992-93 was determined lower, at ₹ 12,000 crore, compared with the actual ₹ 14,726 crore for 1991-92; of this, the share of the Central Government was not to exceed ₹ 5,000 crore.

The debt management measures envisaged by the Reserve Bank included a reduction in SLR on incremental domestic liabilities from 38.5 per cent to 30.0 per cent during the year, a phased movement to market-related interest rates on government securities, institutional measures to activate a secondary market in government securities and funding of part of the existing stock of Treasury Bills.

Concerned about the less than satisfactory GFD position, the Central Government from 1991-92 consistently scaled down its market borrowing programme. Consequently, net market borrowings were placed lower at ₹ 3,670 crore during 1992-93 (₹ 7,501 crore in 1991-92), while gross market borrowings were ₹ 4,821 crore (₹ 8,919 crore in 1991-92). As a strategy to move towards market-related operations, the Reserve Bank, on behalf of the Centre, conducted for the first time auctions of dated securities. During 1992-93, according to the Reserve Bank's records, net market borrowings of the state governments amounted to ₹ 3,471 crore (₹ 3,364 crore in 1991-92).

MARKET BORROWING PROGRAMME FOR 1993-94

Reductions in Fiscal Deficit, Reserve Requirements and Development of Financial Markets, including the Government Securities Market

The letter from the Governor, Dr C. Rangarajan, to the Secretary, Economic Affairs, Ministry of Finance, dated January 7, 1993 advised that the market borrowing programme for 1993-94 was not to exceed ₹ 7,500 crore as against ₹ 12,000 crore in 1992-93. In consonance with the proposed reduction in the GFD of the Centre to 4.0 per cent of GDP in 1993-94, the projections made by the Reserve Bank were to contain the expansion in M_3 at 12.0 per cent and the budget deficit of the Centre at ₹ 4,000 crore. Other important measures contemplated for the year were reductions in the effective SLR and CRR by 2.0 and 1.5 percentage points, respectively, and funding of 364-day Treasury Bills into dated securities while continuing with their auctions. Based on the trends in inflation rate until the middle of December 1992, the Reserve Bank indicated that monetary policy in 1993-94 should curb inflationary expectations while promoting growth, reduce further the reserve prescriptions and progress towards market-related interest rates for government borrowing. The central bank anticipated that as a result of SLR and CRR reductions, a sizeable release of lendable resources to banks would take place, leading to bank credit expansion. The internal debt management policy issues identified were: increase in the amount of the auction 91-day Treasury Bills, reduction in the maximum maturity period of dated government securities, review of the structure of yield pattern of dated securities, issue of zero coupon bonds to minimise interest outgo in the future and development of market infrastructure.

A critical component of the financial sector reforms was the large reductions to be effected in the incremental reserve requirements of banks. Apprehending that a sharp reduction might carry serious implications for the Government's borrowing programme, the Governor in his letter dated February 3, 1993 conveyed to the Government his 'great anxiety' about an effective SLR reduction in 1993-94 that was larger than two percentage points, at the same time conceding that such a reduction of less than two percentage points would affect the 'credibility' of a strong financial sector reform. The Reserve Bank also mooted the idea to the Centre issuing its securities partly at controlled rates with an SLR requirement and partly at market-determined rates devoid of an SLR requirement, but hastened to admit that such a strategy was neither feasible nor conducive to the

development of the government securities market, since it was not advisable to issue securities with the same risk and maturity at widely varying rates of interest. "The choice is to move to market entirely or to mimic the market by controlled but realistic rates," was the perceptive observation of the Governor, Dr Rangarajan. In view of the likely difficulties in adjusting to lower borrowing levels, the Reserve Bank discerned that the latter course (*i.e.*, controlled but realistic rates) was a more feasible proposition, at least for 1993–94. In conclusion, the Governor stated that whatever was decided on the rate and maturity should be made applicable to all government securities and the authorities should not 'artificially fracture' the market.

In this letter, the Reserve Bank suggested tapping mutual funds to finance the large gap of ₹ 4,800 crore in the budget. The entire funds mobilised by the mutual funds were completely free of any reserve requirements. From a prudential viewpoint and as a move towards a level playing field, the Reserve Bank was in favour of prescribing a liquidity requirement in government and other approved securities to the extent of 5.0 per cent of the monthly net asset value of all mutual funds (including that of the Unit Trust of India [UTI]) to be phased in four steps of 1.25 percentage points each during 1993–94. With the total asset value of all mutual funds at around ₹ 50,000 crore, ₹ 2,500 crore at the maximum was expected to be garnered. At the same time, the Reserve Bank clarified that the legal position about prescription of a liquidity requirement for mutual funds was somewhat 'hazy' and, as such, until the Reserve Bank of India (RBI) Act was amended to make the position explicit, it was best to set this requirement as a guideline from the Reserve Bank as part of overall monetary control. Securities and Exchange Board of India (SEBI) guidelines were also expected to reinforce this measure. The Reserve Bank admitted that although introducing a liquidity requirement at a time when there was a back-off from SLR for banks might appear somewhat embarrassing, this could be projected as part of an expeditious move towards a 'level playing ground'. The letter concluded:

I must stress that in the absence of this measure, the borrowing programme for 1993–94 envisaged by the Government cannot be successfully implemented. We need to take an early decision on this matter to ensure that the liquidity requirements for mutual funds are in place early in the financial year 1993–94.

The Reserve Bank, after analysing the monetary and banking data available until the middle of March 1993, conjectured that the estimate

of the resources available for the overall market borrowing programme in 1993-94 remained unchanged at ₹ 7,500 crore, but in the light of the BE for 1993-94 it would be necessary to raise from non-captive resources a large amount of ₹ 6,800 crore at market-related rates. In its letter to the Finance Secretary dated March 27, 1993, the Reserve Bank emphasised the need to explore other avenues for raising such a large amount, including re-examination of the earlier suggestion of imposition of a small reserve requirement of 5.0 per cent of the net asset value on mutual funds (including the UTI). In a subsequent letter dated April 20, 1993 to the Additional Secretary (Budget), Department of Economic Affairs, specific suggestions were made, namely, issuing in the middle of May 1993 the first tranche of state governments' borrowing programme for ₹ 1,200 crore of 10-year duration, limiting the programme of central guaranteed institutions to ₹ 1,270 crore [inclusive of any allocation to the City and Industrial Development Corporation of Maharashtra Ltd (CIDCO)] and continuing the 91-day Treasury Bill auctions throughout the year 1993-94 within a ceiling of ₹ 5,000 crore (outstanding).

In August 1993, the Government enquired of the Reserve Bank about the possibility of increasing the market borrowing allocations in 1993-94. The latter, in its letter dated September 8, 1993, conceded that the deposit growth in the full financial year could be higher than the estimated growth of 13.0 per cent (namely, about 15.5 per cent), but expected the Government to take strong measures to reduce the budget deficit and the automatic monetisation. It was pointed out that despite the higher deposit growth in future, banks might not be inclined to invest further in government securities as they had already large excess investment over and above SLR stipulation. The 'considered' advice of the Reserve Bank was that the borrowing should not be raised merely because monetary expansion was higher than that earlier envisaged; since the basic reason for such larger expansion was the large budget deficit, the Government would soon be required to undertake in the current year a large funding operation for 91-day auction Treasury Bills and, until this was put through, the Reserve Bank was not in favour of sizeable enhancement in the borrowing programme. "While the overall borrowing programme for 1993-94, as approved, is well ahead of schedule, it would be best not to load the programme with large borrowing till existing commitments are successfully completed," the Governor indicated. The Reserve Bank also suggested that this matter could be reviewed by the end of October 1993 after the funding operations.

The BE for 1993–94 placed the gross and net market borrowings of the Central Government at ₹ 4,848 crore and ₹ 3,700 crore, respectively, which were marginally higher than the RE for 1992–93. A significant aspect of the domestic borrowing strategy of the Central Government was the increased reliance on the market through the issue of dated securities, zero coupon bonds, 91-day auction Treasury Bills, 364-day Treasury Bills and funding of Treasury Bills. The Reserve Bank's initial support declined to about 9.0 per cent of the gross market borrowings in 1993–94, as against 45.9 per cent during 1992–93. Moreover, the initial subscription by the Reserve Bank was fully sold off in the secondary market during the year. This indicated the increased market absorption of government securities following the move towards market-related interest rates.

MARKET BORROWING PROGRAMME FOR 1994–95

Impact of Strong Accretion to Foreign Exchange Reserves and the Decision to Phase Out Automatic Monetisation of Budget Deficit

The Governor, Dr C. Rangarajan, in his letter dated December 27, 1993 to the Finance Secretary proposed the market borrowing programme (dated securities) for 1994–95 at a reduced level of ₹ 9,650 crore, of which the Centre's share was ₹ 3,700 crore (excluding funding of Treasury Bills), while a further ₹ 10,000 crore could be raised by the issue of 91-day and 364-day Treasury Bills. This estimate was considered consistent with a GFD of 4.5 per cent of GDP in 1994–95. Perhaps the most important determinant was the decision to curtail during the year the automatic monetisation through the creation of *ad hoc* Treasury Bills so that auctioned Treasury Bills formed two-third of the short-term financing of the Government (*i.e.*, up to 91 days); at any point during the year, net RBI credit to the Centre was not to exceed twice the end-year figure set out as the budgetary estimate and any deviation would trigger an increase in the amount of auctioned 91-day Treasury Bills.

The other measures contemplated during the year in accordance with the overall monetary projections and borrowing programme were: (i) reducing the effective SLR from 33.0 per cent to 30.5 per cent in conjunction with other monetary policy measures; (ii) in view of the prevailing high level of liquidity, CRR was not to be reduced except as a component of any rationalisation without adding to the primary money creation; (iii) lengthening the maturity structure of government dated securities, continuation of the auction procedure and attempts towards

freer interest rates on state government flotations; (iv) funding of Treasury Bills; and (v) development of market infrastructure.

While arriving at the figures for market borrowing for 1994-95, the Reserve Bank provided for a further build-up of liquidity to the extent of ₹ 10,000 crore, over and above the large excess liquidity in 1993-94. This perception, along with the contemplated further reduction in SLR in 1994-95, made the authorities apprehend that sooner or later the smooth floatation of the borrowing programme of the state governments could be seriously disrupted in 1995-96, if not in 1994-95. Under the circumstances, the Reserve Bank advised that it would be extremely 'hazardous' to plan on the basis of a continuing and increasingly large excess liquidity, since, when it became necessary to quickly turn to non-inflationary level of financing of market borrowing, the entire market borrowing programme could be in disarray.

The major source of the large expansion in reserve money (up to November 26, 1993) was net RBI credit to the Central Government, which increased by ₹ 11,989 crore as against an increase of ₹ 9,549 crore in the corresponding period of 1992-93. The sizeable accretion of ₹ 6,111 crore to the foreign exchange assets of the Reserve Bank also contributed to the bulge in the growth of reserve money during the financial year. This would have been substantial but for a decline of ₹ 3,353 crore in scheduled commercial banks' (SCBs) borrowings from the Reserve Bank in the financial year up to November 26, 1993 as against an increase of ₹ 345 crore in the comparable period in the previous year. The Reserve Bank's understanding was that the strong increase in primary liquidity in 1993-94 and the substantial unutilised refinance limits of banks could trigger an explosive increase in the overall liquidity in the economy at very short notice and, as such, the overall monetary situation was very 'vulnerable'.

The price trends also pointed to inflationary pressures touching double digits. For the Reserve Bank, the most disquieting aspect was the exceptionally large monetisation of the deficit of the Central Government. The budget deficit of the Central Government, after recording a high of ₹ 21,755 crore on August 13, 1993, weakened in the following weeks and stood at ₹ 16,529 crore on December 17, 1993, as against the BE of ₹ 4,314 crore for the year. Both the budget deficit and the net RBI credit to the Centre would have been even higher but for the extremely good response to the market auctions of Treasury Bills and dated securities.

Quite apart from the large increase in net RBI credit to the Centre, the borrowings of the Centre from the market in 1994–95 were estimated at an unprecedented ₹ 26,250 crore (BE of ₹ 9,700 crore). The Reserve Bank was, therefore, constrained to point out (in the aforesaid letter): “Drastic measures would have to be taken early to restore fiscal stability; otherwise, the credibility of the financial sector reform measures would be jeopardised and the manoeuvrability of monetary policy responses would be severely impaired.”

The Reserve Bank concluded that within the overall financial policy framework, the opening up of the external sector underscored the need for mutual consistency between monetary policy and exchange rate policy and, accordingly, the objective of monetary policy during 1994–95 should be to bring about a perceptible reduction in the excessive primary money creation and thereby a reduction in the inflation rate. Monetary policy was also expected to provide an enabling framework for implementing the overall financial sector reforms. The Governor reiterated that appropriate fiscal measures were required to be taken to contain net RBI credit to Central Government so that monetary policy had enough ‘head room’ to support growth of output and that, consistent with the projected growth of M_3 and reserve money in 1994–95, the increase in net RBI credit to the Centre was to be contained within ₹ 5,000 crore.

Internal debt management was progressively becoming a vital element for transmitting monetary policy signals and these instruments needed to be further strengthened in 1994–95, the Reserve Bank stated in its letter to the Government. In particular, attention was to be focused on reducing the automatic monetisation of budget deficit if the programme of reduction of SLR to an average of 25.0 per cent by 1995–96 was to be meaningful and also for the development of a healthy secondary market in government securities.

MARKET BORROWING PROGRAMME FOR 1995–96

Onwards to a Cohesive Monetary and Fiscal Policy

In his letter dated December 20, 1994 to the Finance Secretary, the Governor envisioned that the total market borrowing programme for the Centre, states and others for 1995–96 could be reduced to ₹ 30,150 crore compared to ₹ 33,030 crore in 1994–95, of which the share of the Centre under all heads was to be ₹ 23,700 crore. A further amount of ₹ 14,700 crore could be raised through medium and long-term loans and ₹ 5,300 crore by

means of short-term loans (*i.e.*, 364-day Treasury Bills). The creation of *ad hoc* Treasury Bills was not to exceed ₹ 4,000 crore, in accordance with the agreement signed between the Reserve Bank and the Central Government on September 9, 1994 on phasing out the issue of *ad hocs* over a three-year period. The increase in *ad hocs* was not to exceed ₹ 6,000 crore for more than 10 continuous working days at any time during 1995–96 and, if this limit was breached, the Reserve Bank would automatically sell fresh Treasury Bills or dated securities in the market.

The Reserve Bank pointed out that the Centre's total market borrowings in 1993–94 at ₹ 27,151 crore and in 1994–95 at ₹ 26,700 crore were 'phenomenally' high compared with the level of ₹ 8,461 crore in 1992–93, and that this quantum jump was made possible due to very special features, which resulted in banks and other institutions holding very large excess liquidity. Due to the large liquidity overhang in the economy, there arose a compulsion to contain M_3 growth in 1995–96 at 15.5 per cent, and it was felt that it would not be possible to sustain the Centre's borrowing in 1995–96 at the high level of the previous years. On this analogy, the Reserve Bank recommended a diminution in the Centre's total market borrowing from ₹ 26,700 crore in 1994–95 to ₹ 23,700 crore in 1995–96. The other important measures contemplated — consistent with the overall monetary projections and market borrowing programme — were that CRR would not be reduced, the average effective SLR would be lowered from 29.5 per cent at the end of March 1995 to 27.5 per cent at the end of March 1996, and Treasury Bills would continue to be funded as a matter of policy with the objective of elongating the maturity structure. The Reserve Bank decided that against the background of large capital inflows during 1994–95 and the resultant explosive growth in net foreign assets (NFA), the objective of monetary policy in 1995–96 would be to contain reserve money growth and to bring about a significant reduction in inflationary pressures. The thrust of the policy was to persevere with financial sector reforms.

SLR holdings of securities by SCBs in excess of the prescribed level were estimated at ₹ 41,000 crore at the end of March 1996. But the Reserve Bank was not oblivious of the fact that the continued dependence of market borrowing on such excess investment made by a few financial institutions (FIs) could sooner or later pose a serious problem to the authorities since banks and other investors might increasingly explore other outlets for lending and investments, in which case it would no longer be possible to sustain the level of borrowing achieved in 1993–94 and 1994–95. Based

on this assessment, the Reserve Bank advised the Government that any attempt to keep the Centre's borrowing programme at a high level could lead to an explosive increase in interest rates and that this was one reason for scaling down the Centre's total borrowing programme in 1995–96 to ₹ 23,700 crore as against ₹ 26,700 crore in the previous year.

The Reserve Bank stressed (in the letter to the Government) that fiscal and monetary developments in the recent past underscored the need for a cohesive fiscal and monetary policy strategy. The basic objective of fiscal policy (supported by financial sector reforms and monetary policy) was to effect a gradual reduction in the GFD as also in the monetisation of the budget deficit, so as to achieve a sustainable rate of economic growth with reasonable price stability. The objective of monetary policy in 1995–96 was to offset the impact of the persistent large inflow of foreign exchange on monetary expansion. The Reserve Bank averred that the success of monetary policy instruments in containing monetary expansion and inflation would largely depend on the fiscal responses, which had a bearing on the internal debt management strategy. A number of policy measures were suggested to achieve this objective.

First, whereas the CRR limit would not be reduced, it might be necessary to increase the CRR rate over certain segments of banks' liabilities to prevent the attenuation of monetary control because of the shift in liabilities among the various non-resident deposit schemes. However, if the primary monetary expansion turned out to be explosive, the Reserve Bank would have to raise CRR across the board. Second, the overall market borrowing programme was becoming increasingly distanced from the SLR prescription and, therefore, an even faster reduction in the prescribed SLR was considered feasible if the borrowing programme for 1995–96 took off well in the first half of the year. Third, the outstanding 364-day Treasury Bills at the end of March 1995 could be large and maturing of this debt might pose problems for the Government. Therefore, the Reserve Bank considered it prudent to fund a substantial part of these bills into dated securities. Similarly, it was felt that suitable opportunities should be availed of to fund 91-day Treasury Bills into dated securities. Fourth, OMOs impacted on the profits of the Reserve Bank and also raised the interest rates, but these costs were reckoned to be unavoidable. In this connection, the conversion of non-marketable 4.6 per cent securities into marketable high-yielding securities — which the Government had recently approved — was expected to facilitate effective OMOs for overall liquidity management.

Gross market borrowings (consisting of normal market borrowings, other medium and long-term borrowings and borrowings through 364-day Treasury Bills) stood at a high of ₹ 40,509 crore in 1995-96. Despite a substantial increase in interest rates on government paper, there was a devolvement on the Reserve Bank to the tune of 32.8 per cent of gross issues. The lower absorption of government securities by the market was attributable to a number of reasons, *viz.*, the excess liquidity that was present in the banking system in 1994-95 being unavailable in 1995-96, lower growth in bank deposits during 1995-96 than in the preceding year, a tapering off of commercial banks' investments owing to larger demand for credit in response to buoyant economic activity and large stocks of government securities in their investment portfolios in excess of the required SLR stipulations.

In this connection, the Reserve Bank's Annual Report for 1995-96 conjectured that the large market borrowing would necessarily keep nominal interest rates at a level that would result in very high real rates of interest due to the distinctly lower inflation rate. In 1995-96, the Reserve Bank absorbed a sizeable proportion of the new issues, thus preventing a further rise in interest rates although this caused primary liquidity creation. Up to August 2, 1996, the increase in net RBI credit to the Centre in 1996-97 was significantly lower than that in the corresponding period of the previous year, largely because of very transient investments in 91-day tap Treasury Bills.

Government borrowing operations encountered a relatively difficult phase during 1995-96, following a large increase in demand for commercial credit and perceptibly lower growth in bank deposits. With hardening of interest rates, the absorption of government securities by the market was weak. There was large devolvement on the Reserve Bank. The intra-year cap on the issue of *ad hoc* Treasury Bills was exceeded on three occasions for extended periods, and the end-of-the-year limit was also surpassed. Due to relatively tight conditions in the money market, the gross amount raised under 364-day Treasury Bills was distinctly smaller in 1995-96 compared with 1994-95, and net repayments under these bills were substantial.

In 1995-96, concerned over the fact that extremely high real interest rates would affect the economy adversely, the Reserve Bank decided to strike a balance and allowed interest rates on government paper to rise, while absorbing sizeable amounts of government securities in its portfolio by way of devolvement. Such devolvement was to the extent of 32.8 per

cent of the gross central government borrowing. In addition, the Reserve Bank absorbed sizeable amount of 91-day auction Treasury Bills.⁷

MARKET BORROWING PROGRAMME FOR 1996–97

Discontinuation of Automatic Monetisation of Budget Deficit

The total market borrowing programme of the Centre, states and other bodies was determined at ₹ 31,300 crore for 1996–97, of which the Centre's component was ₹ 24,000 crore, as per the Governor's letter dated January 2, 1996 to the Finance Secretary. These figures implied the Reserve Bank's support of ₹ 10,000 crore. A suggestion was made to the Government for consolidation of the Centre's market borrowing under one head rather than three heads, *i.e.*, conventional, medium, long and short-term (364-day Treasury Bills). The repayments of the Centre during 1996–97 were estimated at ₹ 10,500 crore and, consistent with net market borrowing of ₹ 24,000 crore, the Centre's gross borrowing worked out to ₹ 34,500 crore. These estimates for 1996–97 were based on two tenets. First, CRR would not be altered other than for any restructuring and provided such a change did not have an overall impact on monetary aggregates. Second, SLR would not be changed; but as a result of the 25.0 per cent prescription on incremental domestic net demand and time liabilities (NDTL) and zero SLR on certain specific liabilities, the overall effective SLR would continue to decline from an estimated 28.2 per cent in March 1996 to 27.2 per cent in March 1997.

For 1996–97, the year-end figure for the increase in *ad hoc* Treasury Bills was set at ₹ 5,000 crore and the within-the-year ceiling for 10 consecutive working days was ₹ 9,000 crore. The year 1996–97 being the final year of the adjustment programme for phasing out the instrument of *ad hoc* Treasury Bills, the outstanding *ad hocs* as on March 31, 1997 were proposed to be funded into 4.6 per cent non-marketable undated securities. From April 1, 1997, the mechanism of *ad hoc* Treasury Bills was to be replaced by a ways and means limit at the Bank Rate, which had to be cleared before the end of the financial year.

While framing the policy, the Reserve Bank factored in that during 1995–96 there would be considerable difficulty in meeting the Central Government's market borrowing programme and it would have to extend

7. Review of Internal Debt Management Policy and Operations for the period from November 1, 1994 to March 31, 1996: Memorandum to the Central Board of Directors of the Reserve Bank of India dated April 26, 1996.

support to the market on several occasions. By the end of December 1995, the Central Government could raise only ₹ 17,180 crore against the net borrowing of ₹ 27,087 crore and the balance was raised in the last quarter of the fiscal year. The letter advised the Government that the support which the Reserve Bank could provide in meeting the balance to be raised would depend on future trends in money supply and prices. In retrospect, the Reserve Bank was in a position to provide considerable support to the Government in 1995–96, largely on account of a decline in the NFA, but such a situation was not expected to recur in 1996–97. With rising demand for credit, banks might not be willing to augment their holdings of securities above the existing level. Any attempt to raise the Centre's net market borrowing above the figure set out would have a cascading effect on other interest rates in the system. With large repayments due in 1996–97, it was no longer meaningful from policy and operational viewpoints to focus on the net market borrowing programme, as investors could not be expected to automatically reinvest maturities in government paper. Given this uncertain prospect, the Reserve Bank stressed that the Centre should plan for a net market borrowing of ₹ 24,000 crore (gross ₹ 34,500 crore) in 1996–97, which might turn out to be a difficult target to achieve.

The substantial improvement in liquidity, on one hand, and sluggish credit off-take, on the other, led to improved market absorption of government securities, which facilitated early completion of the Government's borrowing programme during 1996–97. The aggregate net market borrowing (including the 364-day Treasury Bills) of the Central Government during fiscal 1996–97 at ₹ 26,356 crore exceeded the budgeted amount of ₹ 25,498 crore (as per Reserve Bank's records). In order to raise this amount, the Central Government accessed the market on 12 occasions, with lower devolvement on the Reserve Bank and primary dealers (PDs), as also with less pressure on the interest rate.

'MARKET-RELATED' BORROWINGS AND GROWTH OF PUBLIC DEBT: AN ANALYSIS

The decade of the 1990s (up to 1996–97) was an era of fiscal consolidation and financial sector reforms that were interlinked in operation. The continuous enlargement in the overall market borrowing of the Centre and state governments inexorably resulted in a large accumulation of domestic debt. There was an increased reliance on the market through the sale of dated securities, 91-day auction Treasury Bills, 364-day Treasury Bills, zero coupon bonds and, last but not the least, the funding of Treasury Bills. A

welcome feature was the increased absorption of government securities following the move towards market-related interest rates accompanied by an active internal debt management policy. In addition, there was a sizeable demand for government paper by institutional investors, principally the commercial banks, which preferred safer means of investment.

Over the six-year period from 1991 to 1997 (end-March), the domestic liabilities of the Government grew two-fold. Of this, market loans expanded nearly two-and-a-half times; the other major component accounting for the rise was the 91-day auctioned Treasury Bills. Also, 91-day Treasury Bills funded into special securities (in 1991–92) at ₹ 71,000 crore was a large item. In 1991 (end-March), it was nearly the size of the market loans, but by 1997 its comparative share came down because of the relatively more rapid growth in market loans and 91-day Treasury Bills (Statement 15.1). Since the borrowings took place at market-determined rates, the burden of interest payments also concurrently escalated.

Growing Burden of Repayment and Amortisation

Perhaps a not so apparent incidence of market borrowing was the accumulated burden of repayments in future due to the steep humps in the repayment schedule, both of the Centre and the state governments. This aspect was not lost on the Reserve Bank.⁸

The total outstanding domestic liabilities of the Government (Centre and states combined) were equivalent to about 54.0 per cent of GDP in 1994–95 as against 56.0 per cent in 1993–94 and 51.0 per cent in 1985–86 (Statement 15.2). It was much higher in 1990–91 (*i.e.*, 59.6 per cent). However, in 1995–96 and 1996–97, this domestic debt-GDP ratio started coming down, albeit slowly. Overall, this trend was symptomatic of a turnaround from the unsustainable debt scenario of the 1980s. The Reserve Bank voiced its concern that accumulation of debt at this pace would have serious implications for the coming Union Budget and the state budgets in terms of higher interest payments as well as larger amortisation.⁹

In 1995–96, interest payments accounted for about 47.0 per cent of the revenue receipts of the Central Government, 15.0 per cent of state governments and 18.0 per cent to 28.0 per cent for the Centre and states together (after adjusting for inter-governmental transactions). Moreover,

8. A specific proposal for placing a ceiling on public debt was suggested in a technical paper on the subject published in the Reserve Bank monthly bulletin, December 1997. This was intended to elicit informed and wider debate on the subject.

9. Reserve Bank of India, *Annual Report, 1994–95*.

this repayment burden was expected to be more severe in the years ahead. Another disturbing phenomenon was a shift in the debt pattern of government securities towards relatively shorter maturities ever since the Government moved to a system of market-oriented borrowing. The proportion of marketable debt in the total domestic debt of the Government increased rather sharply. It only deferred the repayment problem to the future. The rising interest burden on domestic debt (*i.e.*, the ratio of interest payments to revenue receipts) made the Reserve Bank comment:¹⁰

It is, therefore, imperative that the growth in interest payments should be arrested over the medium-term through further reduction in GFD-GDP ratio so as to achieve a perceptible decline in the debt-GDP ratio. This, in turn, would satisfy the necessary but not the sufficient condition, for a sustainable fiscal policy. What is crucial is, however, to generate adequate primary surplus which could meet the entire debt service obligation.

Shifts in Composition of the Debt and Maturity Pattern

Following the move towards market-related interest rates for central government borrowing from June 1992, there was a shift not only in the composition but also the maturity pattern of the Centre's debt from the long end to the short end. The proportion of marketable debt in the total debt of the Government strengthened from 24.6 per cent in 1991–92 to 28.6 per cent in 1995–96. Similarly, the short-term loans (maturity below 5 years) in the total market loans raised by the Central Government escalated from 20.7 per cent in 1992–93 to 64.9 per cent in 1995–96. This movement in favour of short-term debt signified more frequent repayment obligations and the accentuation of amortisation problems for the Government.

The share of dated securities in total domestic liabilities of the Centre increased from 24.6 per cent at the end of March 1992 to 29.9 per cent at the end of March 1997. The larger recourse to borrowing from the market exerted pressure on interest rates and triggered concomitant policy response to minimise the cost of borrowing by placing a large part of borrowings at the shorter end of the market. This compressed the average maturity and gave rise to problems of debt roll-overs. As a consequence, the share of shorter maturities (*i.e.*, under 5 years) in total outstanding

10. Reserve Bank of India, *Annual Report, 1995–96*.

market loans, rose sharply from 7.4 per cent as at the end of March 1992 to 38.4 per cent at end-March 1996.

In its dual capacity as monetary authority and manager of public debt, the responsibility of the central bank became onerous and unenviable. The Reserve Bank posited that even though there were indications of a steady decline in the domestic debt-GDP ratio, there were nagging concerns regarding the high level of public debt and its long-term implications for fiscal stability, which continued to pose challenges for the fiscal system.¹¹ Looking ahead, the Reserve Bank tried to highlight certain critical issues, namely, the long-term macroeconomic consequences of public debt, the stability of the debt-GDP ratio, interest burden and monetisation of debt, viz.:¹²

The long-term macroeconomic consequences of public debt depend on how quickly the volume of public debt grows in relation to the growth in nominal GDP, the extent of increase in private savings in absorbing the additional public debt, and the impact of public debt on monetary situation. The condition for the stability of the debt-GDP ratio implies that the real interest rate must be lower than the growth rate of output which ensures its convergence to a stable value in the long-run. However, the immediate concerns of a high level of debt-GDP ratio relate to its impact in the form of interest burden, the 'crowding out' of productive outlays, the higher proportion of private saving being absorbed by the Government, the pressures on the interest rate and the monetisation of debt.

Reserve Bank's Initial Support to Central Government Borrowings

Statement 15.3 titled: Reserve Bank of India's Initial Support to Borrowings of the Central Government throws up some interesting facts. The 91-day *ad hoc* Treasury Bills, which were issued exclusively in favour of the Reserve Bank and held by the latter as a proxy for financing the budget deficit, went into oblivion consequent to the phased elimination of monetisation of budget deficit (namely, the first supplemental agreement with the Government of India, dated September 9, 1994 and abolition of *ad hocs* from April 1, 1997 in terms of the second supplemental agreement

11. Reserve Bank of India, *Annual Report, 1996-97*.

12. Rangarajan, C. (1997). "Activating Debt Markets in India". *Reserve Bank of India Bulletin*. October.

dated March 26, 1997). The subscriptions to 91-day auction Treasury Bills and dated securities, unlike in the past, did not burden the Reserve Bank, because commercial banks had an appetite for these types of investments (despite large reductions in SLR) due to their security and liquidity features. Moreover, coupon rates came to be related to market trends. The net result was that banks invested in them by choice and not by compulsion.

WITHDRAWAL OF THE 91-DAY *AD HOC* TREASURY BILLS

An epochal event in the long-standing monetary-fiscal inter-relationship was the accord in September 1994 to delink the budget deficit from automatic and unlimited monetisation, thereby vesting the Reserve Bank with greater flexibility in monetary management. Historically, the net Reserve Bank credit to the Central Government had been the predominant factor that propelled primary liquidity expansion. For the Central Government, this development had far-reaching significance by strengthening fiscal discipline and transforming the method of financing the budget deficit.

The Reserve Bank accorded great importance to tackling the debilitating phenomenon of monetisation of fiscal deficit against the backdrop of inflationary pressures gaining strength from excess liquidity in the system. The Central Board of Directors of the Reserve Bank in their Annual Report for the year 1988–89 expressed serious concerns over the emerging situation and its impact on monetary management.

Further, in his Presidential Address at the Annual Conference of the Indian Economic Association held at Calcutta (now Kolkata) in December 1988, the Deputy Governor, Dr C. Rangarajan, articulated the views of the Reserve Bank as follows:

The essence of co-ordination between fiscal policy and monetary policy lies in reaching an agreement on the extent of expansion in Reserve Bank credit to Government. This will set a limit on the extent of fiscal deficit and its monetization and thereby provide greater manoeuvrability to the monetary authorities to regulate the volume of money. It is in this context the introduction of a system of monetary targeting mutually agreed upon between the Government and central bank assumes significance.

On behalf of the Reserve Bank, the Governor, Shri R.N. Malhotra, pursued the issue with the Finance Minister, Prof Madhu Dandavate, in his letter dated December 18, 1989 and urged the Government to launch

corrective measures. These initiatives during the 1980s (and even earlier) have been covered in the chapter titled Monetary-Fiscal Interface.

The Governor, Dr C. Rangarajan, in his letter dated December 27, 1993 to the Finance Secretary, (regarding the Reserve Bank's projections about the market borrowing programme for the financial year 1994-95), charted a strategy for phasing out *ad hoc* Treasury Bills, which ultimately formed the framework for the first supplemental agreement signed about nine months later.

The Reserve Bank postulated that a phased programme of reduction of SLR to an average of 25.0 per cent by 1995-96 would be 'meaningful' only if it was dovetailed into a programme to phase out the automatic monetisation of the budget deficit over a period. The proportion of auctioned Treasury Bills in the total increase in 91-day Treasury Bills (including the 91-day Treasury Bill conversion into a funded security) in 1993-94 up to December 17, 1993 was about 30.0 per cent; this proportion was to be increased to two-third in 1994-95, three-fourth in 1995-96 and from 1996-97 onwards the system of issue of *ad hoc* Treasury Bills was to be completely discontinued (as envisaged then). The Central Government would then be provided a WMA limit from the Reserve Bank to meet its temporary requirements, with the limit liquidated by the end of the financial year. The interest rate on this limit was to be linked to the Bank Rate, as in the case of state governments.

As part of its OMOs, the Reserve Bank would decide on the extent of government paper it wanted to hold. Once the figures of net RBI credit to the Centre and the budget deficit for the full financial year were incorporated in the budget document of the Central Government, net RBI credit to Central Government at any point of time in 1994-95 should not exceed more than twice the budgeted figure; beyond this level, the Central Government would not be provided additional accommodation from the Reserve Bank and it would have to raise additional resources from the market. To operationalise this for 1994-95, the peak permissible increase in net RBI credit to the Centre was envisaged at ₹ 10,000 crore (on the assumption that net RBI credit to the Centre and the budget deficit being set out in the BE was ₹ 5,000 crore). If net RBI credit to the Centre remained above ₹ 10,000 crore for 10 working days, no further increase in net RBI credit to the Centre was to be permitted and the Centre would immediately issue auctioned Treasury Bills or dated securities to set right the position. This scheme was also highlighted in the Reserve Bank's Annual Report for 1992-93.

AUTONOMY OF THE CENTRAL BANK AND FISCAL DISCIPLINE

Besides corresponding with the Government to phase out monetisation of budget deficit, the Reserve Bank expressed its views on strengthening fiscal discipline in public forums also. The Tenth M.G. Kuttu Memorial Lecture delivered by the Governor, Dr C. Rangarajan, at Calcutta on September 17, 1993 was a seminal contribution to this topic. The gist of his speech as it relates to fiscal policy and monetary management is given in the following paragraphs.

On the independence of the central bank *vis-à-vis* funding of the Government by the Reserve Bank, the Governor at the outset stated that since in actual practice central banks could acquire government securities as part of their OMOs, there could not be a ban on the central bank acquiring government debt. While statutory limits on credit to the Government could be got around, quite clearly direct funding of the Government without limit by the central bank might come in the way of an efficient conduct of monetary policy. Nevertheless, the freedom of the central bank to pursue monetary policy according to its judgment required that direct funding of the Central Government be restricted and the limits made explicit.

In the past few years, there had been conscious attempts to contain fiscal deficit and budget deficit, which had strengthened the Reserve Bank's efforts to moderate M_3 growth. However, the system was far from perfect. The Governor pointed out: "So long as the practice of issue of *ad hoc* Treasury Bills continues, there is no immediate check on the expansion of RBI credit to Government." Even in the past few years, when year-end deficits had moderated, deficits 'within the year' had been large. The speech advocated the necessity to move away from the system of issue of *ad hoc* Treasury Bills and the consequent monetisation of the budget deficit. While the ultimate objective was for the Central Government to meet its needs from outside the Reserve Bank, it did not necessarily imply that the central bank would not hold any government paper. "It may and will," the Governor affirmed. As part of its OMOs, the Reserve Bank would decide on the extent of the government paper it wanted to hold. More importantly, with the shift away from automatic monetisation of deficit, monetary policy was expected to come into its own. The regulation of money and credit would be determined by the overall perception of the monetary authority on what the appropriate level of expansion of money and credit should be, which, in turn, was dependent on the behaviour of the macroeconomic fundamentals.

As the system of automatic monetisation of deficit got phased out and pre-emption of funds in the form of SLR came down, the Government would be obliged to place nearly all its borrowings in the market at market-determined rates and, in fact, this situation was being approached. Interest rates on government securities were then in the realm of 'substitutability' — the maximum rate on government securities was 13.5 per cent, while the weighted average lending rate of banks was around 15.0 per cent. The banks' choice of asset holdings would be increasingly determined not by statutory prescriptions, but by the 'risk-reward' perception on securities and bank lending. With market-determined rates, an active secondary market would develop and acquire depth, making it possible for the Reserve Bank to undertake OMOs effectively at its discretion.

In the concluding part of his speech, Dr Rangarajan emphasised that, in the Indian context, the first step should be to move away from a system in which the deficits incurred by the Central Government automatically got financed by the Reserve Bank through the issue of *ad hoc* Treasury Bills, which was distinct from the question of setting limits on government borrowing. To elaborate:

In the context of increasing interest payments, as a proportion of revenue and the consequent preemption of resources for non-development expenditure, there exists a compelling need to see that the Government, either on its own or statutorily limits its borrowing. However, when the borrowing gets monetized, there is an additional impact on money supply growth with all the attendant consequences. Thus, the situation towards which we should move, if not today but at least within a year time frame, is where the central government should borrow whatever amount it wants from the market and not rely on direct credit from the Reserve Bank which is what the issue of *ad hoc* treasury bills does. Then, the onus of responsibility for conduct of monetary policy will be squarely on the shoulders of the Reserve Bank, where it should logically rest.

THE BUDGET ANNOUNCEMENT

The Finance Minister, in the course of presenting the Union Budget for 1994–95, announced in Parliament that there would be a limit on resort to the Reserve Bank for *ad hoc* Treasury Bills by the Central Government. This arrangement was formalised by an agreement between the Government of

India and the Reserve Bank, which was signed on September 9, 1994.¹³ Consequently, automatic monetisation of the budget deficit through the issue of *ad hoc* Treasury Bills was to be phased out over three years and from 1997–98 this instrument was set to be abolished. The Union Budget placed a cap on the net issue of *ad hocs* during the course of fiscal year 1994–95, namely, while the net issue of *ad hocs* in 1994–95 should not normally exceed the estimated budget deficit of ₹ 6,000 crore for the year as a whole, at any point of time during the year the *ad hocs* were not to exceed ₹ 9,000 crore for more than 10 continuous working days. If this limit was breached, the Reserve Bank was authorised to sell fresh government paper to bring down the level of *ad hocs* to the stipulated within-the-year ceiling. After three years (*i.e.*, from April 1, 1997) when recourse to *ad hocs* was to be completely phased out, the Central Government would cease to avail of direct credit from the Reserve Bank for financing the deficit, and meet its entire financing needs through borrowings from the market. For each of the two succeeding years when the agreement was in force, the two ceilings underwent revisions with the mutual consent of both the parties.

The Reserve Bank in its Annual Report for 1994–95 termed this a 'landmark development'; the Government's decision to move to market-related rates of interest and to curb the monetisation of budget deficit by limiting the access to *ad hoc* Treasury Bills was intended to impart an element of financial discipline, and delinking the fiscal deficit from automatic monetisation was essential if the impact of monetary policy was not to be whittled down. However, the Economic Survey for the year 1994–95 was more effusive. It stated that the decisions taken during the year resulted in the link between the fiscal deficit and monetary growth through the budget deficit would be completely broken in the next two years, and that this would make monetary policy independent of the Government and thus devolve much greater responsibility on the Reserve Bank. Further, the interaction between the finance ministry and the central bank would focus on the target growth of M_3 to balance the twin objectives of inflation control and output growth, as was the practice in developed countries.

13. The first supplemental agreement dated September 9, 1994 and the second supplemental agreement dated March 26, 1997 have been reproduced in the 'Documents' section of this history volume.

PHASING OUT *AD HOC*S IN THE PERIOD OF TRANSITION

During the base year 1994–95, within-the-year ceiling under the framework of the supplemental agreement of September 1994 was adhered to and at the end of the year recourse to *ad hoc* Treasury Bills (outstanding) was a modest ₹ 1,750 crore (Table 15.2). The Government's financial position in 1995–96 experienced considerable strain. The within-the-year limit of ₹ 9,000 crore for net issue of *ad hoc* Treasury Bills was exceeded on three occasions for extended periods and the end-of-the-year ceiling was breached to a small extent. At the end of fiscal year 1996–97, the net issue of *ad hoc* Treasury Bills could be contained well within the agreed limits, but the position was different for within-the-year performance. The net issue of *ad hoc* Treasury Bills was high during the first two quarters of the year, but declined rapidly in the third and fourth quarters, largely because of a shift to tap Treasury Bills for financing the budgetary gap. This figure

TABLE 15.2
Net Issues of Ad hoc Treasury Bills
Annual Ceilings Agreed upon for 1994–95, 1995–96 and 1996–97@

<i>Fiscal Year</i>	<i>Within-the-year</i>	<i>End-of-the-year (end-March)</i>
1994–95	(i) Ceiling: ₹ 9,000 crore (BE) (ii) Actual: Within the ceiling (Full-year fortnightly average decline was ₹ 3,249 crore)#	(i) Ceiling: ₹ 6,000 crore (BE) (ii) Actual: ₹ 1,750 crore
1995–96	(i) Ceiling: ₹ 9,000 crore (BE) (ii) Actual: Exceeded the ceiling for extended period on three occasions (Full-year fortnightly average increase was ₹ 10,280 crore)#	(i) Ceiling: ₹ 5,000 crore (BE) (ii) Actual: ₹ 5,965 crore
1996–97	(i) Ceiling: ₹ 9,000 crore (BE) (ii) Actual: Exceeded the ceiling for an extended period during the first half of the financial year (Full-year fortnightly average increase was ₹ 7,612 crore)#	(i) Ceiling: ₹ 5,000 crore (BE) (ii) Actual: ₹ 4,685 crore

Notes: @: as per RBI records.

BE: Budget Estimate.

#: The average of all fortnightly reporting Friday figures for net issue of *ad hoc* Treasury Bills and the end-March figures after the closure of government accounts.

Source: Reserve Bank of India, *Annual Report*, various issues.

even turned negative on a few occasions in the second half of the year; this was the outcome of an improvement in the absorptive capacity of institutions other than the Reserve Bank for the 91-day Treasury Bills, which was facilitated by substantial cuts in CRR during the year.

WITHDRAWAL OF *AD HOC* TREASURY BILLS AND
INTRODUCTION OF WAYS AND MEANS ADVANCES

The Finance Minister's budget speech for 1996–97 in Parliament on July 22, 1996 evaluated that the experience so far to phase out the system of *ad hoc* Treasury Bills by 1997–98 had shown the difficulty of staying below the within-the-year limit. Nevertheless, the Government was not deterred from its resolve to phase out the system of *ad hoc* Treasury Bills:

However, before this could happen, we need to put in place a better expenditure control mechanism. We also need a more transparent method of defining and reporting the true budget deficit, including all forms of monetization. I shall present concrete proposals in this regard at the time of presentation of next year's budget so that the RBI can have greater autonomy in formulating and implementing monetary policy.

Accordingly, in July 1996 the Government requested the Reserve Bank to prepare concrete proposals setting out the modalities to phase out *ad hoc* Treasury Bills from 1997–98. In response, the Reserve Bank forwarded a self-contained note setting out proposals for phasing out *ad hoc* Treasury Bills from April 1, 1997 and also recommended a transparent method of defining and reporting the budget deficit and the monetised deficit. The scheme provided for granting WMA to the Government to meet its temporary mismatches between receipts and payments. The Reserve Bank also took the opportunity to convey its views on a number of related policy issues, namely:

- (i) From the point of view of credible fiscal operations on a day-to-day basis and of having a mechanism to take care of the problem of lags in receipts, especially in the face of leads in expenditure, the Government would need to borrow from the central bank for temporary periods under transparent terms and conditions.
- (ii) A system of providing WMA to the Government of India under section 17(5) of the RBI Act, 1934, could be considered as a possible means of accommodating temporary mismatches in

government receipts and payments from April 1, 1997 onwards after the practice of issuing *ad hoc* Treasury Bills was discontinued. In this regard, it would be useful to draw appropriately from the experience of the system of WMA to the state governments which had been in vogue since 1937.

- (iii) The underlying principle of the WMA arrangement was that it should not become a supplementary source for the Government to finance its budgetary deficits, but would cover only day-to-day mismatches in receipts and disbursements of the Government. There would, therefore, be no WMA in an *ex ante* sense and it could not be a part of the capital receipts or of financing GFD. The temporary accommodation to be viewed as credible by the public should be subject to certain limits.
- (iv) It was possible that temporary cash surpluses might accrue in government accounts on some occasions after vacating WMA. When the cash surpluses went consistently beyond, say, ₹ 100 crore, they could be utilised for premature repayment of maturing 91-day auction Treasury Bills held by the Reserve Bank.

After detailed discussions between the officials of the Reserve Bank and the Ministry of Finance, the second supplemental agreement was signed on March 26, 1997. In terms of the agreement, the practice of issuing *ad hoc* Treasury Bills to replenish the cash balances of the Central Government to the agreed minimum level was discontinued from April 1, 1997. The outstanding *ad hoc* Treasury Bills as on March 31, 1997 were funded into special securities without any specific maturity, at an interest rate of 4.6 per cent per annum, on April 1, 1997. The outstanding tap Treasury Bills at the end of March 1997 were paid off on maturity with an equivalent creation of special securities without any specific maturity, at an interest rate of 4.6 per cent per annum.

From April 1, 1997 the Reserve Bank extended WMA to the Central Government at rates of interest that were mutually agreed upon from time to time and up to the agreed maximum limit. The advances were to be fully paid off within a period not exceeding three months from the date of making such an advance. Interest was calculated on daily balances and debited to the government account with the Reserve Bank at such intervals. In the event of the Government's account at the close of business on any working day emerging and remaining overdrawn beyond the agreed limit for WMA, the Reserve Bank could charge interest on the daily balances

overdrawn at rates mutually agreed upon from time to time.¹⁴ As and when the WMA was drawn upon to the extent of 75.0 per cent, the Reserve Bank would automatically trigger flotations of government securities. On the other hand, if the Government happened to run surplus cash balances beyond the agreed level, the Reserve Bank would make investments as mutually agreed upon.

Thus, the Union Budget for 1997–98 formalised the ‘dismantling’ of the system of *ad hoc* Treasury Bills as announced in the 1994–95 budget. The Reserve Bank expressed the hope (in its Annual Report for 1996–97) that the new system of accommodating temporary mismatches in cash flows of the Central Government by WMA, apart from encouraging fiscal discipline, would contribute to strengthening fiscal and monetary policy co-ordination in several directions. First, the new arrangement would prevent unplanned creation of money through ‘unbridled’ expansion of *ad hoc* Treasury Bills and improve the degree of monetary control in the economy. The explicit and exhaustive nature of the WMA limit during the year would put in place an effective ceiling on the automatic monetisation of the fiscal deficit and create a favourable macroeconomic environment for setting a ‘monetary target’. Second, since the elimination of *ad hoc* Treasury Bills would mean a certain degree of compositional shift in the funding of the fiscal deficit towards market borrowing, it would in due course reflect the true level of the Government’s credit requirement from the market and strengthen the interest rate mechanism. Third, the new system would improve the credibility of macroeconomic policies and dampen the adverse inflationary expectations that arose from the uncertainty inherent in the automatic monetisation of the fiscal deficit. The attainment of this objective, however, required a concomitant discretionary fiscal policy in place that aimed at long-run sustainability of public debt and deficit.

The Reserve Bank also conceptualised certain long-term advantages to flow from this new set up. From the operational point of view, the WMA would necessitate improvement in cash management by the Central Government as well as debt management by the Reserve Bank, so as to keep the cash deficit within the WMA limits for the year. The monthly pattern of the flow of receipts and expenditures of the Central Government over the past three years (April 1994 to March 1997) indicated that, on average, during the first quarter and the fourth quarter, the cash flow mismatches

14. However, the Reserve Bank, in its note (September 1996) outlining the modalities of phasing out *ad hoc* Treasury Bills had suggested that while the WMA would be provided at the Bank Rate, overdrafts would be charged at the Bank Rate plus 2.0 percentage points.

tended to be larger than in the other quarters of the fiscal year. Moreover, there was a high concentration or bulge in both receipts and expenditures in the last month of the financial year. This skewed distribution of monthly flows in receipts and expenditures was particularly glaring in the revenue account. Although the volatility in monthly cash flow of aggregate receipts and expenditures had declined sharply in the recent past, this process would have to be carried substantially further through improved efficiency in cash management. This would be of utmost importance during the next few years — the period of ‘transition’ as per the arrangement — so as to switch over fully to the new system in a smooth manner and to avoid the problems of overdrawing of accounts with the Reserve Bank. The Economic Survey for 1997–98 observed that the discontinuation of the system of *ad hoc* Treasury Bills as a means of financing the budget deficit was a significant step that would further strengthen fiscal discipline, while affording greater autonomy to the Reserve Bank in its conduct of monetary policy.

INTERNAL DEBT MANAGEMENT: POLICY AND OPERATIONS

Management of domestic debt forms an integral and dynamic part of monetary macroeconomic management. The need for an active internal debt management policy in India came into prominence in the wake of the fiscal consolidation process launched in 1991–92. Over the period beginning in the early 1990s, the Reserve Bank fine-tuned the policy framework and operating procedures of debt management.

Whereas the size of market borrowings was determined by fiscal policy, the composition of public debt was determined by debt management operations conducted by the Reserve Bank. The latter denoted the timing, instruments of borrowing, method of issue, maturity pattern of a specific loan and coupon rates. A large part of the Centre’s borrowing programme had to be completed in the first half of the financial year, given the seasonality of demand for credit on private account. The skill of debt management was to insulate, to the extent possible, internal debt from the short-term effects of monetary policy, as also to optimise the maturity and cost of government borrowing from the market. It is also true that much depended on the perception of the future course of interest rates.

The Government’s borrowing programme was budgeted each year and appeared on the receipts side of the Union Budget. The net investible resources was estimated largely on the basis of surplus funds likely to

be available with the banking system (allowing for SLR prescriptions), insurance corporations owned by the Government and provident funds (PFs). While deciding to float a loan, the Reserve Bank took into account the cash needs of the Government, liquidity conditions in the economy, market preference for maturity *vis-à-vis* the repayment schedule of the Government, maturing loans during the year, expectations of the market and the primary and secondary yield curves. There was also an element of judgment by the Reserve Bank in this process. If the system was flush with liquidity and prevailing interest rates were low, it was advisable to float a long-term loan. In conditions of tighter liquidity, while deciding on the maturity, the leeway available to the Reserve Bank was to accept a possible devolvement, which depended on the monetary situation, became an important consideration. On some occasions, *e.g.*, the estimated net RBI credit to the Central Government being well within the acceptable/agreed limits, the Reserve Bank took up a private placement instead of going to the market, especially if it did not want to disrupt the yield curve. A private placement could also be used to beef up the stock of securities for OMOs. Thus, a variety of considerations went into making the borrowing programme successful and transparent. The Reserve Bank attempted to complete the borrowing programme for each year with the objective of ensuring a smooth flow of funds to each of the floatations, while pursuing its interest rate objectives and without jeopardising the external balance.

The Reserve Bank was also responsible for the smooth conduct of overall borrowing programme of the state governments. Generally, state loans were for a single issue and the longest maturity of the central government security issued during that particular year. The coupon rate was also pre-determined. The conduct of the borrowing programme posed several problems, such as the prevalence of large inter-state economic disparities, meeting the preferences indicated by state governments and the unwillingness of banks and other institutional investors to subscribe to state loans in a liberalised environment, unless compelled to do so. While several reforms in debt management policy were introduced in the 1990s in respect of sale of central government securities, the sale of state government loans continued to be on the old pattern and procedures, at least until 1996–97.

ENVIRONMENT PRIOR TO 1991–92

The government bond market before the 1990s was characterised by administered interest rates, high reserve requirements that led to the

presence of captive investors and the absence of a liquid and transparent secondary market for government securities. During the 1980s, the volume of government debt expanded considerably — particularly the short-term debt — due to the automatic and unlimited accommodation that the Reserve Bank was compelled to provide to the Central Government under a long-standing arrangement. The mechanism was through the issue of *ad hoc* Treasury Bills of 91 day duration on behalf of the Central Government. With a captive investor base and low interest rates, the secondary market for government securities remained dormant. The artificial yield on government securities was kept below the market yields, which had an overwhelming impact on the entire structure of financial assets in the system. The distorted yield structure of the financial assets led to an overall high interest rate environment in the rest of the market. Driven by these compulsions, the Reserve Bank's monetary management was distinguished by a regime of administered interest rates, rising CRR and SLR prescriptions, which left little room for monetary manoeuvring.¹⁵ As a corollary, direct instruments of control proved ineffective and there was little scope for deployment of market-based tools like OMOs and Bank Rate.

The Reserve Bank had little operational control over some of the essential facets of debt management. These included the volume and maturity structure of securities to be marketed and the term structure of interest rates or the yield curve, which were not market-related. The maturity structure of market loans remained highly skewed towards the longer term of more than 15 years. The situation was aptly summed up by Dr C. Rangarajan: "Monetary and internal debt management policy in India was undermined by excessive monetization of Central Government fiscal deficit by the central bank."¹⁶

Early Reform Initiatives

The Reserve Bank had taken quite a few important policy measures even before the reform period. The maximum coupon rate on central

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15. Mohan, Rakesh (2006). "Recent Trends in the Indian Debt Market and Current Initiatives," Based on the lectures at the *Fourth India Debt Market Conference* (organised by Citi Group and Fitch Rating India, on January 31, 2006) and at the *Annual Conference of FIMMDA* (jointly organised by the Fixed Income Money Market Dealers' Association of India and Primary Dealers' Association of India), March 14, Mumbai.
 16. Rangarajan, C. (1994). "Developing the Money and Securities Markets in India". Paper presented at the *Sixth Seminar on Central Banking*. International Monetary Fund. Washington, D.C., March 9.

government loans, which was as low as 6.5 per cent in 1977–78, was raised in stages to 11.5 per cent by 1985–86 and the maximum maturity period was reduced from 30 years to 20 years. The coupon rates for 5-year and 10-year loans were stepped up in 1986–87 by one percentage point each to 10.0 per cent and 10.5 per cent, respectively. In November 1986, 182-day Treasury Bills were introduced as a new instrument to serve as an alternative avenue for short-term investment, thereby aiding the development of a secondary market. These bills were sold in competitive auctions held monthly up to June 1988, and fortnightly from July 1988 until April 1992, when they were replaced by 364-day Treasury Bills.

Acting swiftly on the report of the Chakravarty Committee,¹⁷ the Reserve Bank initiated steps to evolve a market-clearing interest rate mechanism for sale of government dated securities. The objective was that the Government should increasingly finance its borrowing needs from the open market and thereby reduce the extent of debt monetisation. Measures were introduced to restructure the maturity pattern and also telescope the interest rate structure on government debt instruments. With a view to develop Treasury Bills as an active monetary instrument, the Reserve Bank revised upwards the yield on these bills, and this led to institutional investors, banks as also other corporate bodies, local government agencies, trusts and individuals, constituting a sizeable market for Treasury Bills and dated securities. In the process, the Reserve Bank's holdings of these instruments would be lowered to a substantial extent, resulting in a corresponding reduction in the Reserve Bank's credit to the Government and hence, in reserve money. In the long run, this was expected to give a fillip to the development of money and capital markets and improve the overall efficiency of the financial system.

The Discount and Finance House of India Ltd (DFHI) was set up by the Reserve Bank as a money market institution. It initially aimed at affording liquidity to 182-day Treasury Bills and short-term commercial bills, which imparted greater flexibility to banks in their fund management operations. To perform its functions effectively, DFHI was provided with refinance from the Reserve Bank. By varying the quantum and the rate of interest on refinance to the DFHI, the Reserve Bank was able to transmit signals to the short-term money market.

The Narasimham Committee had recommended that interest rates on government borrowing should progressively be made market-related

17. Refer to Appendix 4.1 for details.

in order to facilitate the reduction in SLR. Over the years, a regime of moderation of the GFD and an active internal debt management policy assisted in the integration of debt management policy with monetary policy.

EVOLUTION OF POLICY

The Reserve Bank recognised as early as in 1992 that the development of a vibrant, deep and broad government securities market should be an essential piece of financial sector reforms for various reasons. First, in order to conduct sizeable OMOs without undue adjustment to interest rates, sufficient market depth was necessary. Second, a broad and deep market to absorb new issues of government securities without residual reliance on the Reserve Bank facilitated macroeconomic stabilisation. Third, an efficient securities market, which established a market-based curve, could act as a benchmark for other rates of return and thereby transmitted quickly the monetary policy impulses to the rest of the economy. Fourth, a well-developed government securities market would be supportive of exchange rate policy. Fifth, a liquid secondary market reduced the cost to the Government of raising long-term debt and elongated the term maturity of outstanding debt.¹⁸ To sum up, the healthy development of the market for government securities not only strengthened monetary policy, but also helped fiscal policy and developed financial markets in general.

For the first time, in 1991–92 the Reserve Bank declared its intention to activate the internal debt management strategy. The letter from the Governor, Shri S. Venkitaramanan, dated January 2, 1992 to the finance ministry (in regard to the market borrowing programme and monetary projections for 1991–92), *inter alia*, enunciated, “As part of the development of the financial system, it would be necessary to activate internal debt management policy, reduce the pre-empted resources under the SLR, move towards marked related rates for government securities and develop a secondary market in securities.” This letter also contained far-reaching suggestions for reducing SLR, increasing the coupon rates on government dated securities, developing an active secondary market in dated securities, dispensing with the interest rate cap on 182-day Treasury Bills, introducing Treasury Bills with a maturity of 273 days and 364 days on auction basis

18. Note on *Issues in Developing the Government Securities Market and Open Market Operations in Support of Financial Sector Reforms*, prepared by the IMF Advisory Mission to Study the Government Securities Market in India, headed by Mr Sergio Pereira Leite. July 1992. Annex II to this chapter gives the main recommendations of the Leite Report.

and enhancing the discount rate on 91-day Treasury Bills. The monetary policy announcement in April 1992 (circular to commercial banks dated April 21, 1992) marked a new approach to internal debt management by introducing market-orientation with regard to absorption of Government of India (GoI) rupee dated securities and longer-term Treasury Bills. In furtherance of developing dated government securities as a monetary instrument with flexible yields to suit investor expectations, the Central Government started to sell these securities of different maturities through auction from June 3, 1992. Earlier, auctions for sale of Treasury Bills of 364-day duration were introduced in April 1992. With the proposed reduction in the effective incremental reserve requirement from 63.5 per cent to 45.0 per cent, the Reserve Bank re-organised the gilt-edged market. Keeping this in view, a number of innovations were introduced to move towards a market-related internal debt management policy.

The Reserve Bank in its Annual Report for 1991–92 articulated that with a view to promoting an active market for government securities, the gilt-edged market was being re-organised in such a way that the Government reduced its dependence on credit from the Reserve Bank and the banks. The Reserve Bank was adopting an internal debt management policy that would serve as a tool of monetary control with flexibility in interest rates, introduction of new instruments and liquidity expansion/contraction through OMOs. In another context, the report expressed the view that the move towards market-related interest rates on government dated securities and Treasury Bills was a prerequisite for successful reform of the financial system as also the pursuit of an effective monetary policy.

Additional measures were taken in October 1992 to develop the government securities market and, in the process, alleviate to some extent the problems that arose from a dormant secondary market. A new refinance arrangement, called the government securities refinance facility, was introduced from October 31, 1992 at a rate of interest of 14.0 per cent, repos auctions in central government securities commenced with a view to even out the liquidity within the fortnightly make-up period and IDMC was set up (in the Reserve Bank) as a policymaking unit from April 1, 1992.

In fact, serious discussions had been in progress much earlier between the monetary and fiscal authorities for evolving an active internal debt management policy, and the Reserve Bank was eager to start active internal debt operations in the April–June 1992 quarter as evidenced by its letter dated April 20, 1992 to the Finance Secretary. The Reserve Bank in the letter urged the ministry to take early decisions on four issues, namely: (i)

removal of the discount rate cap of 11.5 per cent on 182-day Treasury Bills as well as on 273-day and 364-day Treasury Bills (proposed to be issued shortly on auction basis) and leave the choice of maturity at each auction to the Reserve Bank, depending on its perceptions of the conditions in the short-term money market; (ii) the existing 91-day Treasury Bills auctions not to be subject to an interest rate cap; (iii) periodic funding of these bills into dated securities; and (iv) auctioning of the 5-year dated securities without an interest rate cap but with a reserve price and Reserve Bank intervention. A year later, the Reserve Bank reaffirmed its commitment to activating the internal debt management system in its letter to the Government dated January 7, 1993 (relating to projections for the market borrowing programme for 1993–94) thus:

During 1992–93, a number of measures have been taken to evolve an active debt management policy and the measures include the introduction of 364-day Treasury Bills on an auction basis, auction of Central Government dated securities, Repos auctions, the recently announced auction of 91-day Treasury Bills and the raising of the maximum interest rate on Government dated securities. We admittedly have a considerable amount to traverse before open market operations become the principal instrument of Reserve Bank's intervention. Hence, we need to reinforce the measures taken in 1992–93 by further measures in 1993–94 and in particular, we need to give attention to the institutional structure necessary for developing the secondary market in securities.

The Annual Report of the Reserve Bank for 1992–93 (as also the report for the following year 1993–94) devoted a separate section to Internal Debt Operations in its thematic chapter on Monetary and Price Trends, which signified its growing importance in monetary policymaking. The report for 1993–94 averred that internal debt management assumed added importance in the face of the large monetary expansion engendered by capital inflows and the consequent inflationary pressures, and that in the context of easy liquidity conditions in the economy it was possible to contain the cost of government borrowing despite the borrowing requirement being high.

OVERVIEW OF DEBT MANAGEMENT POLICIES AND PROCEDURES

As far back as January 1991, the Reserve Bank gave serious thought to developing an active market for government securities by re-organising

the gilt-edged market in such a way that the Government reduced its dependence on credit from the Reserve Bank and banks. With this objective, the Reserve Bank suggested to the Government in January 1991 and January 1992 to introduce various internal debt management measures. However, it was only after April 1992 that these measures could be initiated, after obtaining the concurrence of the Government.¹⁹

In furtherance of the financial sector reforms, the most important initiatives taken by the Government and the Reserve Bank were: resort to market-related government borrowing; a shift from direct to indirect tools of monetary regulation, most notably activating OMOs; innovations in money market and government securities market instruments; development of secondary market in government securities; and phased elimination of automatic monetisation of central government budget deficits. The principal objectives were to smoothen the maturity structure of debt, enable debt to be raised at close to market rates and improve the liquidity of government securities by developing an active secondary market. Shri S.S. Tarapore, Deputy Governor, who at that time was entrusted with the responsibility of re-orienting internal debt management, observed: “When the definitive history of the post-July 1991 economic reform process is written up, the activation of internal debt management policy will perhaps stand out as the single most important element in the reform process.”²⁰

While the various policy measures taken during the period from 1991–92 to 1996–97 in different segments, such as the government securities market, coupon rates on government dated securities and Treasury Bills, have been described elsewhere, the gist of policy formulation during this period, both by the Reserve Bank and the Central Government, is given below.

In 1992–93, the second year of reform, the main features of the re-oriented debt management were, to reduce the statutory pre-emption of the resources of commercial banks to achieve a more efficient use of their resources on one hand and to make government dated securities attractive to investors (other than those in the captive category) on the other. This

19. A detailed account of the developments may be found in the article, “A Review of Internal Management Policy and Operations for the Period ended March 1995”, *Reserve Bank of India Bulletin*, November 1996.

20. Tarapore, S.S. (1994). *The Role of an Active Debt Management Policy in the Economic Reform Process*. Speech delivered at the Department of Economics, Mangalore University. Mangalore. September 19.

objective was to be achieved by issue of securities at market-related rates, primarily through a system of auctions (introduced on June 3, 1992). The 364-day Treasury Bill auction started from April 28, 1992. Since these auctions were conducted every fortnight, it was expected that at any point in time the market would have bills of varied maturities up to 364 days. Therefore, auctions of 182-day Treasury Bills (issued on a limited scale since November, 1986) were discontinued.

From January 8, 1993, 91-day Treasury Bill auctions commenced. Moreover, interest rates were allowed to respond to the market situation within an overall ceiling. For the first time, in 1992–93, the Central Government raised its entire gross market borrowing of ₹ 4,821 crore through the auction system. While the Reserve Bank initially subscribed ₹ 2,214 crore, the bulk of these securities were later sold in the market. Following the introduction of an auction system, coupon rates for central government loans emerged through cut-off yields at which competitive bids were accepted in auctions. The Reserve Bank conducted periodic auctions of repurchase agreements (repos) for central government dated securities to even out short-term liquidity in the banking system within the fortnightly make-up period. This was another step towards activating OMOs. The first auction was held on December 10, 1992. Initially, the repo auctions were for very short periods of one or two days. The cut-off repo rate generally tended to move in tandem with other short-term rates and also took into account the 91-day Treasury Bill rate. After an initial period of experimentation, the repo period stabilised at 14 days from August 1993, consistent with the reserve make-up period for banks. The Reserve Bank envisioned a multi-pronged role for an active debt management policy in its Annual Report for 1992–93 as follows:

...it is here [attempt to reduce the use of instruments of direct monetary control and to give greater attention to the development of indirect instruments of monetary control over the money and securities markets] that there is a need to co-ordinate monetary and internal public debt management policies so that the two segments are mutually supportive. The Government securities operations are a key element in the evolution of a well-developed system of monetary control. For open market operations to be really effective, it is necessary to have an active secondary market for Government securities. If such a secondary market is to develop, it is essential that there should be investors other than

captive investors. It is only when non-captive investors become predominant that the secondary market can develop depth and it is only under these conditions that it is possible to develop a system of primary dealers who would underwrite the entire issue at the auctions and thereafter access these securities to final investors. An important feature of a well developed securities market is that the Reserve Bank should not take up any part of a primary issue of a Government security but it should buy and sell securities as part of its open market operations, depending on its assessment of the liquidity of the system. An active secondary market in securities requires that there must be institutions dedicated to foster the secondary market.

The Government placed its market borrowing through auctions during 1993–94, and funding was undertaken to lengthen the maturity pattern of rapid accumulation of short-term debt by way of Treasury Bills. SLR on incremental deposits was fixed at 25.0 per cent from September 17, 1993. Interest rates on government dated securities over the period were lowered from a maximum of 15.0 per cent to 13.0 per cent and the maximum maturity was shortened from 20 years to 15 years. The Government floated in January 1994 zero coupon bonds of 5-year maturity on auction basis for the first time to test the market for such an instrument. One salient aspect of debt management in 1994–95 was the emphasis on development of an institutional infrastructure for a secondary market in government securities. The Reserve Bank issued guidelines for enlisting PDs in the government securities market on March 29, 1995. In order to develop a vibrant secondary market in government securities, the Securities Trading Corporation of India Ltd (STCI) was set up and it commenced operations on June 27, 1994. Its objective was to make available improved liquidity to government paper and to stimulate market-making activity by other parties. To provide greater transparency as also information on secondary market transactions in government securities and Treasury Bills, the data on daily transactions in subsidiary general ledger (SGL) accounts reported at the Public Debt Office (PDO) and the Public Accounts Department (PAD) at Mumbai were released regularly from September 1, 1994.

A system of delivery *versus* payment (DvP) was started in Mumbai from July 17, 1995 for transactions in government securities to reduce counterparty risk and the risk of diversion of funds through securities transactions. The system operated through the SGL accounts maintained with the PDO

of the Reserve Bank. A new line of reverse repo facility was opened up for the DFHI and the STCI by way of liquidity support. The mechanism of reverse repos enabled the Reserve Bank to indirectly intervene in the market to correct undue upward pressure on call money rates. In its credit policy circular dated April 17, 1995 the Reserve Bank enunciated that while the link between monetary policy and budget deficit had 'weakened' due to the historic accord between the Government and the Reserve Bank limiting the Government's unilateral access to borrowing through *ad hoc* Treasury Bills, there were several aspects that had a bearing on controlling the overall growth of money and credit. It added that the continuance of large fiscal deficits necessitated the Government's large recourse to market borrowing and this posed a problem for monetary management, as under such circumstances it became difficult to undertake OMOs to the desired extent without pushing up interest rates to unduly high levels.

Following the move towards market-related rates of interest for central government securities, there was a shift not only in composition but also the maturity pattern of the Centre's debt from the long end of the market to the short end. The large market borrowing had the potential to keep nominal interest rates at a level that would result in very high real rates of interest due to the distinctly lower inflation rate. In 1995–96, the Reserve Bank absorbed a sizeable proportion of the new issues, which prevented a further rise in interest rates although this resulted in primary liquidity creation. The mounting interest obligations budgeted at ₹ 60,000 crore for 1996–97 (₹ 52,000 crore in 1995–96) and the accumulation in government debt pointed to emergence of debt management problems, which were aggravated by marked shortening of the maturity structure of fresh issues of government securities together with generally high interest rates being paid on government paper. The Reserve Bank expressed the view that large and persistent deficits would militate against the objective of pursuing growth along with non-accelerating inflation.²¹ The new arrangement of WMA to the Central Government in force from April 1, 1997 — in lieu of the accommodation by issue of *ad hoc* Treasury Bills — was expected to improve debt management practices by the Reserve Bank. In 1996–97, the Reserve Bank continued to be concerned that the growing size of debt had led to bunching of repayments, besides increasing concentration of borrowings at the shorter end of the maturity spectrum.

21. Reserve Bank of India, *Annual Report, 1995–96*.

INTRODUCTION OF AUCTIONS: A CHEQUERED PATH

The introduction of the auction method for issuing government dated securities, including Treasury Bills, was by far the single key innovation in active debt management policy pursued since the early 1990s. The essence of auctioning was to ensure that the price discovery of government securities was competitive and market-based. This was not an easy task because within the Reserve Bank and also outside among the major participants, such as commercial banks, insurance companies and PFs, it meant embarking into an entirely new realm. Further, the non-market practices and methods in vogue could not be dispensed with by following a 'big bang' approach, as this would have caused serious dislocation. The early period of public debt management reform until about 1997 was, therefore, characterised by non-market practices receding and the market-based methods getting entrenched, but in a slow and a gradual manner. As a result, the market had to be nurtured in the initial period with detailed meetings with treasury managers before practically every auction to explain the procedures, method of bidding and the likely range in which the bids could be expected to fall, depending on past trends and liquidity conditions. By around 1996, the system got established and market participants became comfortable with the procedures evolved by the Reserve Bank. Several institutional reforms, including the modernisation in settlement practices, helped this process.

EARLY IMPEDIMENTS

Any new system faces teething troubles, and the introduction of the auction method was no exception. A few major impediments, which the Reserve Bank had to overcome, are illustrated here.

One major impediment in using the auction process was the prevalence of issue of *ad hoc* Treasury Bills of 91-day maturity at a fixed and below-market discount rate of 4.6 per cent. Added to this was the regular issue of 91-day tap Treasury Bills, available on tap from the Reserve Bank with unlimited rediscount facility. Market participants could acquire these bills at will and rediscount them with the Reserve Bank as and when needed. At any point of time, banks and state governments with cash surpluses were the major holders of tap Treasury Bills. In this environment, the Government not only got used to making a substantial part of their borrowing through this 'cheap' instrument, but also did not bestow any thought on efficient handling of its cash management. The monetisation through these bills, therefore, tended to remain high.

Second, thanks to the Reserve Bank's open window for 91-day Treasury Bills, the Central Government showed a lack of interest even in raising the fixed coupon rates of loan flotations.²² In fact, due to this legacy, the Government in the initial stages of auctioning dated securities and Treasury Bills was indicating the yield or specifying a ceiling on yield that was to be fixed in an auction. Though this contravened the fundamental principle of fixation of yield on a competitive basis in an auction, the Bank was able to take this in its stride, since it was a passive participant in having to take up any unsubscribed portion of notified issuance amounts in auctions. This was gradually overcome by progressively avoiding devolvement on its own account and encouraging participants to bid, using moral suasion as needed and evolving the procedure of under-writing by the PDs by 1996.

Third, the weak knowledge base of market participants had to be tackled by practically educating treasury managers of banks and others in the auction method and procedures. It needs to be mentioned that there were instances of wrong bidding that, to maintain the integrity of auctions, had to be accepted by the Reserve Bank's auction committee, occasionally resulting in substantial loss to certain participants. This, nevertheless, did not come in the way of the auction system taking deeper roots over time.

Fourth, while the elimination of *ad hoc* Treasury Bills and tap Treasury Bills had to wait until early 1997, the Reserve Bank had to manoeuvre strategically around the prevailing distorted system. The auction system initially started with the introduction of 182-day Treasury Bills in 1986, following the recommendations of the Chakravarty Committee and as part of the efforts to develop new money market instruments. The Government advised that the ceiling rates be fixed in these auctions. Despite the setting-up of the DFHI in 1988, both primary and secondary market volumes in 182-day Treasury Bills remained subdued. With the launch of financial sector reforms and activation of debt management beginning in April 1992, efforts were made to develop Treasury Bills of longer and varied maturities. The auctioning of 364-day Treasury Bills was introduced in April 1992, which became instantly popular with market participants. The auction mechanism was extended to repo auctions (introduced in December 1992), with the main objective of absorbing excess liquidity from the system and steering the net RBI credit to the Government target under the IMF loan programme in effect at that time.

22. Refer chapter 3: Monetary-Fiscal Interface.

An early step away from the system of *ad hoc* Treasury Bills was to introduce auction sales of 91-day Treasury Bills. This initially met with resistance, because of the low interest rate on *ad hoc* and tap Treasury Bills and the likely higher yield on auction bills. The Governor, Shri S. Venkitaramanan, ultimately succeeded in introducing 91-day Treasury Bill auctions by convincing the Government that the cost on account of interest rate differential would be compensated through transfer of profits from the Reserve Bank.

Fifth, beginning in 1993, the auction method was extended to the sale of dated government securities. But in the early stages, with a view to building a market and making the securities attractive, the maturities were kept below 10 years, which also took into account that the state governments continued to borrow at 10-year maturity and the coupon rate was to be fixed for state flotations. State government securities were treated on par with those of Central Government and the Reserve Bank was not inclined to make any discrimination on state securities' yields as an SLR instrument. Thus, in the first stage in each financial year, the Reserve Bank fixed the coupon rates of state government securities for 10-year maturity administratively. At the lower end, 364-day Treasury Bills offered the auction-based yield for one-year maturity. The dated securities of the Central Government were issued in the range of 2 years and 9 years, and gradually the primary market yields provided some kind of a market-based yield curve. During the year, the yield structure was actually influenced by the Reserve Bank through moral suasion and the bidding process to offer the yield of a security along the primary market benchmark already set through previous auctions.

Sixth, as a result of shortening of the debt maturity, redemption turned out to be a problem in the middle of the 1990s, with maturities bunching in the case of shorter maturities including 364-day Treasury Bills. This was mitigated by introducing the conversion of existing shorter maturities with issuance of longer-maturity securities. This method started with the conversion of 364-day Treasury Bills, and was extended to other shorter-maturity dated securities (more on this later in the chapter). Here, both the redemption price of the security being converted as also the issue price of the new security were determined through the auction process. Participation in such auctions was voluntary. This method proved to be very effective in overcoming the refinancing problem in the early stages before the auction system took root.

Seventh, several innovative instruments such as zero coupon bonds, partly paid stock and floating rate bonds were issued through the auction method. This provided market participants with an opportunity to diversify maturity, undertake refinancing and manage liquidity risks while participating in auctions. Most of these instruments proved to be a success and treasury managers showed great enthusiasm in subscribing to these new issues.

Last, but not the least, both the Reserve Bank and market participants were on the learning curve and progressed with higher levels of skills and knowledge through mutual consultations and discussions. These processes led ultimately to the evolution of guidelines for PDs and the formation of the Fixed Income Money Market and Derivatives Association of India (FIMMDA). These initial interactions also served subsequently as a prelude for the Reserve Bank to form a technical advisory committee on money and government securities markets.

AUCTION METHOD

When a choice had to be made between two types of auction methods, namely, the multiple price auction and uniform price auction (popularly known as the European and Dutch auctions, respectively), the multiple price auction was preferred, though the Reserve Bank later experimented with the uniform price auction. The advantage with the multiple price auction was that bidders were required to pay the price/yield that they quoted. It was felt that the Government could maximise its revenues in that process; in the case of uniform price auctions, every bidder was allocated securities at the cut-off yield/price uniformly. While the uniform price auction satisfied the economists' popular concept of a single price, the multiple price auction was also associated with the problem of the 'winners' curse', which roughly meant that successful bidders at lower yields than the cut-off who won the auction would find it difficult to sell securities in the secondary market without incurring losses in their books. International experience of these two methods was mixed.

Another choice to be made was between yield-based and price-based auctions. Since market participants were familiar with 'coupon rates' and 'yields', initially the auctions were yield-based and price equivalent formed the purchase value of the security. Hence, when the cut-off yields were fixed at odd fractional values, these securities carried odd coupon rates that were set equivalent to the cut-off yield. This process was rationalised over time, when price-based auctions were introduced.

Yet another issue related to communication of auction results. The knowledge base was not uniform across all participant groups. While foreign banks and some public sector banks (PSBs) with active treasury departments were quick to pick up experience in bidding and trading, other banks, including state co-operative banks, lagged behind. This raised the question of the type of information to be disclosed about auction results. Initially, only the cut-off price/yield, the amount accepted at the cut-off, partial allocation amount and the balance unsubscribed amount, if any, taken up by the Reserve Bank were announced to the public. The implicit reason was that if weighted average price/yield was also made known, it would give an idea of the bid distribution in the auction, which would be taken advantage of by only a group of participants who were relatively more adept at treasury operations. It was in early 1996 that for the first time the weighted average price/yield was also announced along with the cut-off.

One more problem encountered was the timing and manner of announcing the auction results. In the initial stages, pending the issue of a press release, the IDMC of the Reserve Bank responded to phone calls and announced the cut-off price/yield. Following complaints from some participants, this practice was discontinued. There was also a complaint that all media persons were not getting access to press communications at the same time. This was resolved by the results being announced simultaneously to a group of media persons at an appointed time of day. This responsibility was entrusted to the press relations division (PRD), which organised information dissemination and fine-tuned this process over time by announcing the results at a fixed time of the day.

DICHOTOMY BETWEEN AUCTION YIELDS AND SECONDARY MARKET YIELDS

In the absence of an active secondary market for government securities, the auction-based yields of different maturities initially provided the basis for the 'primary market yield curve'. In fact, this curve showed kinks across maturities, since it was a combination of yields that emerged at different points in time. Nevertheless, this was used after some smoothing was done internally and served the purpose of announcing sale/purchase of securities in OMOs. The secondary market development was also affected in the early 1990s by the adverse impact of the securities market scam and the removal of brokers from the government securities market who had played a major role in the secondary market. Though in parallel the limited use of brokers with regulatory safeguards was in vogue especially for non-

bank participants, inter-bank trades were to be mostly done directly. The introduction of the DvP system also took some time. In the meanwhile, the Reserve Bank evolved the practice of announcing prices and yields of all securities that were settled in SGL accounts at the end of the day. This provided some information base for secondary market trades.

An outcome of this development was that the primary market and secondary market yields did not converge that soon. Since primary yields were still distorted by participation from non-competitive bidders and the Reserve Bank itself, the price discovery through auctions was not in alignment with secondary market yields. This wedge between the secondary market and the primary market yields at any point of time created the problem of proper pricing of securities for OMOs. The Reserve Bank at this stage evolved a complex procedure of constructing after every new auction of dated government securities a 'primary market yield curve adjusted for secondary market yields'. This was a unique practice, but a compromise that was necessary. Since this curve was used for announcing indicative yields to banks for valuation of government securities in their portfolio at the end of the financial year. At the end of March 1994, when securities yields touched a peak, banks were required to provide considerable depreciation in their tradeable portfolio because of the significantly high yields. In fact, to reset the yield curve for the purpose of valuation, the Bank offered to conduct an open market auction, but unfortunately the auction was not a success and failed to serve the intended purpose. In any case, the Reserve Bank was absolved of its role in fixing a high yield for valuation for that year-end. Ultimately, when the FIMMDA was formed, it was given the responsibility of announcing indicative yields for valuation of securities by banks.

CENTRAL AND STATE SECURITIES

In the above process, it was observed that the market was pricing state government securities at a higher yield than central government securities. Therefore, the Reserve Bank discontinued the practice of applying the same yield curve for central and state government securities. But all state government securities were issued at a fixed coupon rate and flotation was combined for many states. It was possible that some states that deserved a better treatment due to their relatively better fiscal parameters had to grudgingly accept the situation. The eventual introduction of the auction method for state government securities much later corrected this, but discussion on that aspect is beyond the scope of this history.

CERTAIN OPERATIONAL ASPECTS OF INTERNAL DEBT MANAGEMENT

In its secular objective to activate internal debt management policy in an environment of economic liberalisation, the Reserve Bank took a number of initiatives to broaden the government securities market as well as to develop the secondary market in such securities. This was primarily directed towards re-invigorating the Treasury Bills market, which was critical for meeting the short-term financial needs for the Government as well as being a critical component of OMOs. The Government's broad concurrence with these measures enabled the Reserve Bank to quickly introduce changes in the internal debt management system, which ultimately increased the efficacy of monetary management and also helped meet the challenges posed later by the huge inflow of foreign funds.

*Government of India Dated Securities
Auction Sales of 5-Year Dated Security*

Towards the close of the year 1991–92, high level discussions took place with the Ministry of Finance to draw an active internal debt management policy and to start active operations in the quarter of April–June 1992. The Governor, in his letter to the Finance Secretary dated April 20, 1992, strongly recommended introducing an auction system for sale of government securities without an interest rate cap but with a reserve price and Reserve Bank intervention. “You will appreciate that interest rate cap and open market operations would be a contradiction in terms,” reasoned the Governor. In elaborating this aspect, the letter stated that since the Reserve Bank would be in a position to set a reserve price and intervene at its discretion, an element of ‘proactive’ market operations would emerge in place of the prevalent restrictive operations under which the Reserve Bank absorbed securities passively and, more importantly, the reserve price mechanism would moderate a very large increase in interest rates.

Increase in Coupon Rates

The Reserve Bank discerned in early 1989 that, given the relatively low interest rates on government securities *vis-à-vis* other instruments floated by the Central Government, there was a strong case for enhancing the coupon rates on the former. Notwithstanding this perception, at that time the Reserve Bank preferred to keep the rates unchanged with a view to providing some ‘stability’ for the rates (letter dated January 7, 1989 to the Government).

Later, in May 1990 the Reserve Bank recommended to the Government the need to increase the coupon rates on government securities, as the subscriptions to these securities were predominantly at the maximum maturity of 20 years. In terms of the prevailing structure of coupon rates, the rate varied from 10.0 per cent in the case of securities having a maturity period of 5 years to 11.5 per cent for those with a maturity period of 20 years, or an increase of one-half of one percentage point for every 5 years' elongation of maturity. The Deputy Governor's letter dated May 3, 1990 to the Finance Secretary proposed that in the interests of flexible use of different maturities in the Centre's market borrowings without raising the interest burden on the Government, the structure of coupon rates and maturities could be narrowed by keeping the rate for 20 years' maturity unchanged at 11.5 per cent. Moreover, since the 6-month Treasury Bill rate was close to 10.0 per cent, it was considered apt that the coupon rate for securities of 5 years' maturity should be at least 10.75 per cent to attract some funds at lower maturities and thus activate the secondary market.

In its annual policy letter (dated January 8, 1991) to the Government on projections for the market borrowing programme for 1991-92, the Reserve Bank placed this issue in its macroeconomic context, *i.e.*, the measures being taken by the Reserve Bank to minimise the distortions that arose from low administered interest rates, on one hand, and various steps taken by the Government to ensure that the resources were priced correctly, on the other. In the immediate preceding years, the government borrowings other than under the market borrowing programme had been increasing rapidly and the effective cost of such borrowing, taking into account the fiscal concessions, was substantially higher than the rates paid under the market borrowing programme. The Reserve Bank emphasised that extremely high reserve requirements and below the market rates of interest on the Government's marketable debt, far from improving resource allocation, caused avoidable distortions and, more importantly, the monetisation of a large part of the government borrowing. Allaying the fears of the Government that higher interest rates on government securities might raise the cost of servicing internal debt, the central bank countered that instead the market-related rates on government securities would widen the demand for these securities, thereby reducing monetisation of the deficit and, eventually as inflation was brought under control, the cost of borrowing would come down as nominal interest rates declined.

This subject was again pursued in the Reserve Bank's letter dated May 11, 1991 on the grounds that the maximum coupon rate had remained

unchanged over the past five years, whereas interest rates in general had moved up recently. While taking note of the Government's concern about the large interest burden, the central bank stressed that it was a good policy to ensure that the rate on government securities was not too far out of alignment with other rates prevailing in the system. The suggestion to the Government was to move up the prevalent rate structure by at least 0.50 percentage points as a recognition of overall financial stringency, but if the decision required some more time, the proposal was to compress the rate structure and float an 11.5 per cent security for 15 years. In other words, as an interim measure, the maximum coupon rate was to be left unchanged, while the maturity was to be telescoped. The Government was requested to convey its decision early, as the first tranche of borrowing for 1991–92 was scheduled to be announced during May 1991. However, the Government was not favourably disposed towards the proposal. In a letter dated June 6, 1991, the Additional Secretary (Budget) countered that any change in the interest rate structure would impact both the central and the state governments and that in any case it was not the appropriate time to consider these changes.

Consequently, the Governor, Shri S. Venkitaramanan, took up the matter with the Finance Secretary in his letter dated June 4, 1991, when market interest rates had started to firm up. The other reasons were that the interest rates on loans of over ₹ 2 lakh by commercial banks were raised from April 13, 1991 by one percentage point, from 16.0 per cent (minimum) to 17.0 per cent (maximum); imposition of an interest surcharge of 25.0 per cent on import financing; a sharp increase on post-shipment export credit interest rates for periods over 90 days and 180 days; two increases in the maximum term deposit rates in October 1990 and April 1991; and the moves by FIs to remove the ceilings on interest rates on lending and the ceiling on debenture rates. The Reserve Bank advised that in this milieu keeping the coupon rates on central government dated securities unchanged was clearly not 'appropriate'. Further, since 1985 when coupon rates were fixed, the cost of funds to the banking system had considerably increased and reserve requirements had been raised; in such a situation, keeping coupon rates unaltered on these securities would further erode the profitability of banks. The Governor reasoned in a persuasive manner that an upward revision in the coupon rates was 'unavoidable', and the country might be vulnerable in negotiations with international financial agencies, if the rates were kept unaltered, *viz.*:

It would be best not to have to do a sharp change after we go to the Fund and finalise the settlement. I would, therefore, suggest that tactically it would be desirable before we undertake any further negotiations with international agencies to at least implement the suggestion in Dr. Rangarajan's letter (dated May 11, 1991) to raise the maximum rate by 0.5 per cent. If a decision on Alternative I which involves a rise in the maximum rate by 0.5 per cent would need a few weeks, we could go ahead with Alternative II which does not involve a change in the maximum rate for the Centre's first tranche of borrowing which is to be issued in the next few days.

The Finance Secretary in his letter dated June 12, 1991 responded that the changes suggested by the Reserve Bank would be considered and decisions taken in due course; meanwhile, the Reserve Bank could go ahead with floating the first instalment of central and state government loans for the year, because several state governments were likely to run into ways and means problems very soon. After a long delay, the Government accorded its approval in September 1991 for an increase of 0.25 percentage points for maturities of 5, 10 and 15 years (as against the 0.50 percentage points proposed by the Reserve Bank) and a rise of 0.50 percentage points for 20 years' maturity.

This topic again came to the fore in the context of the recommendations contained in the report of the Narasimham Committee. The Reserve Bank, in its letter dated January 2, 1992 (market borrowing programme exercise for 1992-93), addressed to the Secretary, Economic Affairs, reiterated that as part of the reform of the financial system there should be a phased movement to market-related interest rates on government securities, and that in the long run government dated securities would need an active market that presaged market-related interest rates. "While there are certain apprehensions that a sudden freeing of these interest rates would be disruptive, a phased programme could be considered under which interest rates on Government securities could be raised in stages and the rates could be telescoped to different maturities," the Bank emphasised.

In early 1992, the dated securities market was gripped with uncertainties. As a result, banks and other traditional subscribers to the bonds of state governments and state government bodies were staying out of the market in anticipation of changes in the interest rates of dated securities, about which speculation had been rife ever since the submission of the report of

the Narasimham Committee. The Governor in his letter dated February 21, 1992 to the Finance Secretary stated that there was no way in which the Reserve Bank could ensure that these flotations were subscribed, and that despite holding down the amount to be accepted under the 182-day Treasury Bill auctions, banks and other FIs were not subscribing to state government issues. Moreover, the Reserve Bank substantially reduced the offers of 182-day Treasury Bills to a token sum in the next few auctions. The Reserve Bank, in its capacity as the manager of public debt, suggested that the Government might review the interest rates and put in place a new structure from March 1, 1992, implying that the last tranche of the central flotation of ₹ 1,208 crore would also have to be floated at the revised rates. A related recommendation was that to avoid the authorities getting locked into high interest rates for the long term, medium-term maturities should be issued at a higher rate.

The Government's response was prompt as well as positive. After discussions between the Finance Minister, Governor, Finance Secretary, Secretary (Economic Affairs) and Deputy Governor, the Government, in its letter dated March 6, 1992, conveyed its agreement to raise with immediate effect the coupon rate on 15-year securities from 11.50 per cent to 12.50 per cent per annum. Subsequently, the coupon rates for 5-year and 10-year securities were raised in April 1992 from 10.75 per cent and 11.00 per cent to 12.00 per cent and 12.25 per cent, respectively. The Finance Minister also consented to the Reserve Bank's proposal for introducing Treasury Bills with a maturity of 273 days and 364 days on auction basis, at a discount rate cap of 11.50 per cent. Incidentally, the 182-day Treasury Bills, which were being sold on auction basis, had no interest rate cap.

For quite a long time, the Government did not relent on its stand against the removal of the cap on coupon rates, compelled by considerations of the interest rate burden. In connection with the market borrowing programme for 1994–95, the Government in its letter dated May 16, 1994 conveyed the approval of the Finance Minister for the first auction of 10-year bonds for an aggregate amount of ₹ 1,200 crore, with a rider that the cap on interest was to be maintained at 12.00 per cent per annum. The Governor, Dr Rangarajan, spoke to the Chief Economic Adviser to the Government of India about the problems of such a cap, especially as there was a pre-determined amount to be raised by the auction and the 10-year security issued at the end of March (conversion of 364-day Treasury Bills) was at 12.50 per cent and the same rate was fixed for the state governments' 10-year security in April 1994. The Reserve Bank's perception was that

while the Centre should be able to raise loans at a rate somewhat lower than the states, the tightening of monetary policy (announced on May 14, 1994) would have an upward impact on interest rates in the auctions. The problem of a rigid cap of 12.0 per cent was explained to the Finance Secretary, that is, the Centre had a heavy borrowing programme in 1994–95 and a poor market response could send the ‘wrong’ signal. Finally, the Government acceded to a 12.35 per cent cap, which was applied as the cut-off for the auction held on May 23, 1994.

TREASURY BILLS

The resolution of the issues that surfaced during the formulation of the policy on Treasury Bills was more complex than in the case of government dated securities, mainly because the Government was extremely wary about the interest burden in servicing the debt.

Improving the Yield on 182-day Treasury Bills

For the year 1990–91, the yields on short dated 5-year government securities went up from 10.0 per cent to 10.5 per cent, which were expected to induce investors to retain a large part of the outstanding 182-day Treasury Bills until the end of March 1991. The Reserve Bank suggested (in letter dated October 22, 1990) to the Government that to provide some manoeuvrability in managing the auctions, the cap on the cut-off yield on this instrument might be raised from 10.0 per cent to 10.5 per cent. Surprisingly, the Government took the stand (in letter dated November 9, 1990) that the existing cap of 10.0 per cent on 182-day Treasury Bills was adequate and seemed ‘reasonable’ considering that the yield on 5-year government securities was 10.5 per cent. After the Governor discussed the matter with the Finance Secretary, the Government agreed that the yield in 1990–91 could be raised to 10.5 per cent, which would help to get a reasonable proportion of the maturing Treasury Bills reinvested.

The Reserve Bank was not very comfortable with the approach to the cap on interest rates. The Governor, in his letter dated January 8, 1991 (which pertained mainly to the projections for the Government’s borrowing programme for 1991–92) to the Finance Secretary suggested that in the context of the overall stance of financial liberalisation, the cap on the interest rate on 182-day Treasury Bills should be completely dispensed with in 1991–92 and the Reserve Bank given the freedom to mobilise resources for the Government by altering Treasury Bill rate from time to time. “The Reserve Bank should use this flexibility bearing in mind

the overall administered interest rates on dated securities,” indicated the Governor. Incidentally, the Reserve Bank proposed that state governments and PFs should be allowed to participate in the 182-day Treasury Bill auctions on the basis of non-competitive bids, namely, at the weighted average of accepted bids. The Chief Economic Adviser to the Government of India in his letter dated April 10, 1991 replied that, keeping in view the cost on account of this form of borrowing, the lower cap of 10.0 per cent might be reverted to. This stand of the Government was not acceptable to the Reserve Bank and the Governor made a remark on the letter: “I do not agree to this, considering our overall approach to liberalisation. Please put up a letter to F.M.” However, the Deputy Governor, Dr Rangarajan, discussed this with the Chief Economic Adviser and followed it up with a detailed letter dated August 20, 1991, elaborating the rationale for the Reserve Bank’s point of view. The main argument was that in the auctions held during the year (up to August 21, 1991), it had been able to mobilise substantial amounts, reduce marginally the yield and yet collect sizeable amounts. Moreover, it was expected that by raising the yield, the Reserve Bank’s hand in monetary management would be strengthened, *viz.*:

I hardly need to stress the beneficial effects of reducing the extent of reserve money particularly in the context of short-term management at the present time. You will appreciate that we would be well advised to use all the available tools in the armoury to attain the objectives of short-term management and given the present inflationary context and the upward increase in certain interest rates in the present period, it would not be apposite to lower the cap on 182-day Treasury Bills from 10.5 per cent to 10.0 per cent. We would, of course, use the cap with due discretion to the advantage of overall monetary control as also garner resource for the Government and thereby reduce the Government’s dependence on the Reserve Bank.

The 182-day Treasury Bills evoked a favourable response from investors. The outstanding bills as on November 1, 1991 stood at ₹ 3,376 crore, and the cut-off yield ranged between 9.95 per cent and 10.08 per cent. The Reserve Bank, in January 1992, apprised the Government that its endeavour had been to garner the maximum resources for the Government in the 182-day Treasury Bill auctions at a reasonable cost. It enquired whether the cap of 10.5 per cent could be completely dispensed

with in 1992–93 and if it could be given the freedom to mobilise resources for the Government by auctioning 182-day Treasury Bills at ‘appropriate’ rates, since this would provide the Reserve Bank with the flexibility to raise and lower the rate in accordance with the Government’s short-term needs and in due course develop this as an adjunct to monetary control. The Governor assured the Ministry that the Reserve Bank would use this flexibility with caution, bearing in mind the overall structure of interest rates on dated securities.

In February 1992, the Reserve Bank became concerned when it came to know that the Ministry of Finance was seriously considering suspending 182-day Treasury Bill auctions. The Governor, Shri S. Venkitaramanan, in his letter dated February 5, 1992 to the Secretary, Economic Affairs, remonstrated that this would be a most ‘unfortunate’ step and suggested that the matter be discussed in detail before such a drastic decision was taken. The Reserve Bank enumerated various benefits of this instrument. It was a means to garner additional resources and served as an important short-term money market instrument. If the Government was concerned about the GFD, the Governor postulated that the increase in 182-day Treasury Bills did not *ipso facto* alter the GFD, as this was determined more by the Government’s receipts and payments position; on the contrary, this deficit financed by net RBI Credit to Government could be reduced by mobilising the 182-day Treasury Bills.

The Reserve Bank reasoned that it was not valid to compare the cost of raising 91-day Treasury Bills at a discount rate of 4.6 per cent with the cost of 182-day Treasury Bills at around 10.0 per cent, since the former, which was really the inflationary burden of created money, was being kept artificially low. In the interests of the Government’s commitment on net RBI credit to the Government, the need to curb created money, the consequent inflationary pressures and finally the development of the financial system, the Governor urged that the auctions of 182-day Treasury Bills should not only be continued but also the maximum amount be raised. The Government seemed to have veered round to the Reserve Bank’s views, because 182-day Treasury Bill auctions continued without interruption for some time.

Longer-maturity Treasury Bills

The sales of 182-day Treasury Bills followed a seasonal pattern, rising in the first half of the financial year and tapering-off in the second half of the year. This meant that the support to the Government at the end of the year

was limited. Therefore, the Reserve Bank in its letter dated January 8, 1991 mooted having auctions for 273-day and 364-day Treasury Bills. It was envisaged that with the development of an active secondary market by the DFHI, these long-dated Treasury Bills could become popular and provide greater support to the government budget in the second half of the year. By April 1992, the Government had agreed to introduce Treasury Bills of these maturities, but with a discount rate cap of 11.5 per cent. The Reserve Bank's letter dated April 20, 1992 apprised the Government of certain modalities in implementation. First, since the Reserve Bank did not hold any 182-day Treasury Bills, it would not hold any 273-day and 364-day Treasury Bills either. The DFHI would, however, provide liquidity to these longer-term Treasury Bills. Second, the broad strategy was to issue initially only single maturity at each fortnightly auction, although this procedure was to be reviewed as the market developed. Third, the Reserve Bank indicated that the choice of maturity at each auction should best be left to the Reserve Bank, since it would depend on its perceptions of the conditions in the short-term money market. "The endeavour would be to ensure that the Government was not faced with large net repayments of Treasury Bills, particularly in the latter part of 1992–93," the Bank emphasised. Fourth, and most important, the Reserve Bank again emphasised that there was a pressing need to remove the discount rate cap of 11.5 per cent as it intended to vary the discount rates to reflect market conditions. In actual practice, the discount rates varied from auction to auction and the cap put a constraint on the efforts of the Reserve Bank to raise the maximum amount possible at an optimal rate.

With a view to providing financial instruments with varying short-term maturities to cater to the needs of different classes of investors and thereby developing the Treasury Bill market, Treasury Bills of 364-day duration were introduced in April 1992.²³

23. In the investment committee meeting of the Secretary's Department, which took place in April 1992, the proposal to issue Treasury Bills for all the three maturities (*i.e.*, for 182, 273 and 364 days) either in one auction or in different auctions initially found favour. But after some discussion, the case for 273-day Treasury Bills lost ground for three reasons. First, if all the three maturities were offered at a time, as in the case of dated securities, the investors' preference would be for the longest maturity, *i.e.*, 364 days. Second, the 364-day Treasury Bills after running for 3 months would automatically be of 273 days' duration. Third, if three types of maturities were floated, it would be necessary for the Reserve Bank to decide upon different yield spreads in consultation with the Government, *viz.*, the minimum and maximum yields for each type of maturity, to avoid overlaps and distortions in the yield structure.

Sale by Auction of 91-day Treasury Bills

A decisive step towards activating the debt management operations and a gradual move away from the system of *ad hoc* Treasury Bills was the introduction in April 1993 of sale by auction of 91-day Treasury Bills for a predetermined amount, but with Reserve Bank participation in each auction as necessary. The system of *ad hoc* Treasury Bills was continued.

The Reserve Bank's letter dated April 20, 1992 conveyed its views to the Government on the functioning of the scheme. The amount to be raised at each auction was to be predetermined and there would be a reserve price with Reserve Bank intervention. While the Reserve Bank would not provide automatic rediscounting facilities at a predetermined price, it would retain the option to subscribe to these bills under the reserve price and buy and sell these Treasury Bills depending on its perception of market conditions. The DFHI would extend strong backing to this instrument by offering an element of liquidity at a price. Particular emphasis was laid on the fact that the 91-day Treasury Bills auctions should not be subject to an interest rate cap and that in all these operations, the Government should look at the average effective cost of borrowing over a period of say, a year, and not restrict these operations by imposing discount rate caps for each auction.²⁴ The Government was advised to periodically have recourse to funding of these securities into dated securities, the maturity period to be dependent on the absorption capacity of the market. Taking a long-term view, the Reserve Bank proposed taking up periodic funding of these Treasury Bills, *viz.*:

Furthermore, market operations in Treasury Bills will be smooth only if we undertake a periodic funding of these bills into dated securities of say 5–15 years which would need to be absorbed by the market. A large overhang of Treasury Bills built over a number

24. In the office note, a number of objectives and advantages were seen in introducing 91-day Treasury Bills. The important among these were: (i) to absorb excess short-term liquidity in the market; (ii) to even out interest rates in the call/notice money market and reduce the volatility in call money rates; (iii) to popularise 91-day Treasury Bills as a money market instrument with discount rates closer to market-related rates; (iv) reduction in net RBI credit to Government by encouraging holdings of Treasury Bills for 91-day by non-RBI investors; and (v) development of an active secondary market in government securities through repos or otherwise, as there would be no rediscount facility from the Reserve Bank.

of years would jeopardise the effective functioning of the Treasury Bill market and absorption of dated securities by the Reserve Bank cannot be construed as a genuine funding operation as it merely would result in created money.

Nearly six months later, the Reserve Bank again took the initiative to request the Government (letter dated October 19, 1992) to approve the pending proposal, pointing out that in accordance with the objective of improved short-term monetary management, the authorities had a commitment to issue short-term securities at market-related rates to the extent of ₹ 2,500 crore. To allay the fears of the Government, the Reserve Bank clarified that while the auctions would imply a higher cost to the Government, the additional burden (estimated at ₹ 30 crore) was unavoidable, and to keep such a burden within manageable limits, the amount was being restricted to ₹ 2,500 crore in 1992–93. The Governor clarified that the gain had to be measured in terms of avoiding monetisation and inflation and reassured the Government by stating: “I had argued earlier on behalf of the Reserve Bank that the excess income of RBI could be returned to GoI as additional profits. In principle, this agreement continues to hold. We can discuss modalities for doing this.” The Government seemingly took the latter averment rather too seriously, as is evident from what followed.

The Government’s letter dated November 4, 1992 informed the Reserve Bank that the Finance Minister had approved the scheme of auction of 91-day Treasury Bills and noted that the Governor’s proposal indicated a discount rate of 9.5 per cent per annum. Further, the letter made a specific mention: “We have also taken note that the extra cost to Government in 1992–93 will be compensated by the Bank through transfer of additional profits in 1993–94.” The Reserve Bank hastened to clear the Government’s perceptions on these two vital aspects, in its letter dated December 3, 1992:

...the calculation of the additional interest burden during 1992–93 of the order of ₹ 30 crore was based on an illustrative average effective rate of 9.5 per cent as against 4.6 per cent discount rate at present. As already discussed with you, the illustrative rate of 9.5 per cent is not intended to be used as a ceiling rate. We would, however, keep in mind the fact that the Government has made a provision of additional ₹ 30 crore for these Treasury Bills.

The excess income from this instrument would accrue to the RBI only to the extent the RBI holds these Treasury Bills.²⁵

In the first auction held in April 1993, the implicit cut-off yield for 91-day Treasury Bills at 11.0997 per cent was significantly higher than the fixed discount rate of 4.6 per cent per annum. Thereafter, apart from certain fluctuations, the rate generally drifted downwards until early June 1994. On the few occasions that the Reserve Bank participated in the auctions, it was a passive participant, with the market determining the rate. To sum up, the 91-day auction Treasury Bill served as a powerful instrument for financial market participants and heralded a significant move towards market-related rates of interest on government securities.

Interest Rate Cap on 182-day Treasury Bills

The Reserve Bank and the Government had an understanding since June 1987 that while the cut-off yield on 182-day Treasury Bills could fluctuate, the former would ensure that the yield did not exceed 10.0 per cent per annum. Since then, the yields rose gradually from 9.01 per cent in June 1987 to 9.07 per cent in the auctions held in October 1990. The quantum of outstanding 182-day Treasury Bills showed a nearly six-fold jump during this period and, from the auctions of April 18, 1990 onwards, the cut-off yield remained static at 9.97 per cent or just near the 10.0 per cent cap fixed by the Government. This instrument turned out to be useful not only for investment of short-term surplus funds, but was also attractive in view of the liquidity it provided. However, the Reserve Bank noticed that while the outstandings tended to come down at the end of March, the Government secured support from this source year after year as was evident from the steady rising trend in the outstanding level at the end of March each year. Another interesting feature was that investments in Treasury Bills tended to rise during the early part of the year, thereby providing the much-needed assistance to the Government when its receipts were at a low level.

Funding of Treasury Bills

In the 1970s, the Reserve Bank had been funding Treasury Bills in small quantities, mainly to correct the uneven distribution of maturities of

25. Incidentally, the surplus profits of RBI transferred to the Central Government had jumped from ₹ 350 crore for 1990–91 (July–June) to ₹ 1,500 crore for 1991–92 and were maintained at that level for each of the years 1992–93 and 1993–94. This item increased more than two-fold for 1994–95, viz., ₹ 3,558 crore.

outstanding central loans in various financial years and partly to replenish the Reserve Bank's holdings of particular loans and meet the requirements of banks and other investors during the Bank's OMOs. Another objective was to provide high-yielding long-dated securities to various PFs. Internally, the need for funding Treasury Bills was felt acutely to get over the problem faced by the Reserve Bank in finding eligible assets for transfer to the Issue Department as statutory backing for note issue. Between 1958 and 1982, the Reserve Bank had funded *ad hoc* Treasury Bills for an aggregate amount of ₹ 3,795 crore.

During the 1980s, the funding of *ad hoc* Treasury Bills took place on three occasions, viz., March 31, 1982 (₹ 3,500 crore), March 31, 1987 (₹ 15,000 crore) and March 31, 1988 (₹ 17, 500 crore). No funding of *ad hocs* was resorted to between 1983 and 1986, or in 1989 and 1990. This was followed by funding on March 31, 1991 (₹ 30,000 crore) and March 31, 1992 (₹ 5,000 crore). The funding took the form of issue of special securities that carried the coupon rate of interest applicable on Government of India Treasury Bills of 91-day maturity, i.e., 4.6 per cent per annum.

Funding of 91-day Ad Hoc Treasury Bills (March 1991)

In 1991, the Reserve Bank decided that a large portion of 91-day *ad hoc* Treasury Bills needed to be funded for several reasons. The volume of Treasury Bills in January 1991 was nearly ₹ 40,000 crore and would be soon due for a large volume of discharge after their tenure. The discount rate on 91-day Treasury Bills at 4.6 per cent per annum had remained unaltered for over 16 years. The Reserve Bank, in its letter to the finance ministry dated January 8, 1991, suggested that these 'purposeless exercises' could be dispensed with and a major funding into undated securities undertaken at an interest rate of 4.6 per cent at a slightly lower cost to the Government compared with the discount rate of 4.6 per cent.

A year later, in its letter dated January 2, 1992 (in connection with the annual projections for the Central Government's market borrowing programme for 1992-93), the Reserve Bank apprised the Government that the state governments investing in this instrument had pleaded 'not without force' that the yield on 91-day Treasury Bills was 'unrealistically low' relative to other rates in the system and that there was a case for increasing the discount rate to 9.0 per cent per annum. The Governor, in his letter, made the proposal attractive for the Government by suggesting that: (i) the bulk of the existing 91-day Treasury Bills could be funded

into undated securities at 4.6 per cent at the end of March 1992; (ii) the discount could be raised initially to 9.0 per cent and later the rate could be determined at auctions; and (iii) increase in earnings of the Reserve Bank as a result of this measure could be transferred to the Government.

Funding of 91-day Auction Treasury Bills

With the ongoing tempo of issue of 91-day auction Treasury Bills, its outstanding level crossed the ceiling of ₹ 5,000 crore by the 39th auction on October 1, 1993. At the same pace, by the 40th auction on October 8, 1993, the outstanding level of 91-day auction Treasury Bills was expected to touch ₹ 5,450 crore. The IDMC, in its letter dated September 18, 1993, informed the Ministry of Finance that the market response to these bills was overwhelming, with no devolvement on the Reserve Bank in the weekly auctions (August–September 1993) and, with the discount rate coming down, funding would have an ‘enduring’ effect on monetised fiscal deficit. Therefore, the Reserve Bank in its letter dated October 5, 1993 proposed that the funding operation be undertaken on October 15, 1993 by issuing two-year government stock at a pre-announced fixed coupon rate. Based on its experience in funding 364-day Treasury Bills in April 1993, the Reserve Bank felt that pricing the bills on the basis of the holding period yield applied on the maximum weighted average price would be attractive and beneficial to investors opting for conversion.

The advantages adduced to the proposal were three. First, the funding operation would help to obviate the cash flow problem for the Government arising during the latter part of the fiscal year when liquidity conditions might turn out to be tight. Second, as the bills had almost been absorbed by the market, funding would secure a longer-term reduction in the monetised portion of fiscal deficit and, moreover, the conventional deficit would be smaller. Third, in the absence of funding, the manoeuvrability of the Reserve Bank in keeping up the tempo of fresh issues of these bills would be constrained, because turning over a large volume of bills every three months was a very difficult task, especially as the volume of such bills increased.

Ad hoc Treasury Bills amounting to ₹ 34,130 crore were converted into special securities without any specific maturity at an interest rate of 4.6 per cent per annum, effective April 1, 1997. Similarly, 91-day tap bills amounting to ₹ 16,688 crore were converted to special securities on similar terms as they matured during the period April–June 1997.

Funding of 91-day Treasury Bills (March 1994)

Before the start of the borrowing programme for 1994-95, the Reserve Bank wanted to get through the funding of 91-day Treasury Bills outstanding at the end of March 1994 for the same reasons cited earlier in the case of 91-day auction Treasury Bills, namely, to alleviate the cash flow problem for the Government and to enable the Reserve Bank to keep up the tempo of fresh issue of bills in the following year. The Reserve Bank, in its letter to the Government dated March 29, 1994, suggested extending the inter-bank repos facility to the 5-year government stock to be issued in conversion of Treasury Bills, provided the transactions were carried out at Mumbai and through SGL accounts.

Funding of 364-day Treasury Bills (March 1993)

The 364-day Treasury Bill auctions were introduced in April 1992. At the end of March 1993, the outstanding 364-day Treasury Bills were expected to be over ₹ 8,500 crore; this was much in excess of the modest budgeted figure of ₹ 500 crore for the year 1992-93. There was a strong demand for these Treasury Bills due to special reasons, such as the portfolio adjustments made by investors, this being a new type of security; the setback to the secondary securities market in the aftermath of the irregularities in securities transactions; and the attractive rate offered on these bills — especially before the maximum rate on dated securities was raised to 13.0 per cent. The Reserve Bank, in its letter dated January 7, 1993 to the Government, conjectured that retiring these bills (expected to take place in the financial year 1993-94) could be a large drain on the resources of the Government unless an equivalent amount was raised in the auctions to be held in 1993-94 and, therefore, recommended floating a 3-year funding security at an attractive rate before these bills matured towards the end of April 1993. This was open only to holders of 364-day Treasury Bills. Of the 364-day bills eligible for conversion, amounting to ₹ 8,777 crore (face value), into 12.75 per cent central government stock, 1996, ₹ 7,123 crore (face value) was offered by holders for conversion, representing about 80.0 per cent of the eligible bills.

Again in March 1993, the Government was approached to fund 364-day Treasury Bills maturing in 1993-94 into dated securities on the grounds that the bills issued during 1992-93 would mature for payment in 1993-94, leading to high net discharge of bills and cause an imbalance in funds flow to the Government. The letter dated March 17, 1993 favoured making the terms of funding sufficiently attractive to smoothen the flow

of funds and, since these bills did not need be held by investors until maturity, the Government was not required to pay prematurely 100.0 per cent maturity value. The Reserve Bank's Annual Report for 1993–94 propounded that the funding operations of 364-day and 91-day Treasury Bills were an important aspect of internal debt management, because each of these funding operations was large and the back-up of liquidity through repos provided a benchmark for other operations and more important, just as the 12.75 per cent three-year stock at the time of the April 1993 funding of 364-day Treasury Bills acted as a signal for a sharp up-trend in coupon rates, the March 1994 funding of 364-day Treasury Bills could serve as an indicator for lowering coupon rates. Further:

Thus, an array of market-related interest rates are emerging through auctions of conventional market loans, new instruments like Zero Coupon Bonds and funding operations. In a market-related system it is not always necessary for the coupon rate to be determined at the auctions. It is equally legitimate as part of a debt management strategy to test the market by an offer at a certain coupon rate; the fixed coupon rate on the funding of securities is particularly suited as the holder of a Treasury Bill has the option to convert Treasury Bill into a dated security or to opt to remain in Treasury Bills. Conjectural variation between investors and borrowers is a legitimate market play.

In March 1994, the Reserve Bank discerned that with the prevailing easy liquidity conditions, there was a large demand for 364-day Treasury Bills in 1993–94, and the outstandings of these bills touched ₹ 19,263 crore on March 4, 1994. With one more auction to be held on March 16, 1994, the total outstandings at the end of the financial year might be over ₹ 20,000 crore. The strong demand for 364-day Treasury Bills was partly a reflection of the shortage of dated securities in the market, as was evident from the fact that large sales from the Reserve Bank's portfolio of dated securities had taken place in the past three months. The Reserve Bank, in its letter dated March 7, 1994, strongly recommended to the Government a funding operation of 364-day Treasury Bills towards the end of March 1993 as this would ease the cash flow problem of the Government in 1994–95 and, in the absence of funding, the manoeuvrability of the Reserve Bank to maintain the tempo of fresh issues of these bills would be constrained, as turning over a large volume of bills could be difficult, especially as the volume of such bills increased.

The Reserve Bank, in its letter dated December 12, 1994, proposed that a part of the remaining target of net borrowing could be achieved by funding 364-day Treasury Bills maturing between January and March 1995 to be undertaken on December 29, 1994. It was reasoned that if all eligible bills were converted, the funding would cost the Government ₹ 3.73 crore; even if 50.0 per cent of the eligible bills were converted, this would be satisfactory, as it would reduce the remaining borrowing to be undertaken. In another letter dated December 20, 1994, the Reserve Bank expressed the view that since the maturing of large volume of outstanding 364-day Treasury Bills at the end of March 1995 could pose problems for the Government, it would be prudent to fund a substantial part of these bills into dated securities.

Conversion of Special Securities into Marketable Securities

The conversion of ₹ 7,000 crore of special securities (4.6 per cent) into marketable securities was mooted by the Reserve Bank in its letter dated October 31, 1994. But the Government — in its letter dated December 2, 1994 from the Chief Economic Adviser — was not in favour, because it would entail hidden transfer/subsidy and given the move towards greater transparency (evidenced by the supplementary agreement between the Reserve Bank and the Ministry of Finance to phase out *ad hoc* Treasury Bills), similar transparency was required in the profits and losses arising from the open market and sterilisation operations of the Reserve Bank. More important, any change in the Reserve Bank's profits/losses would impact the government budget through variation in dividends.

The Government responded that instead 4.6 per cent special securities up to ₹ 7,000 crore could be exchanged for an equal value of dated securities of appropriate maturity at a coupon rate equal to the corresponding market interest rate. The Reserve Bank was to pay in perpetuity the difference between this coupon rate and the 4.6 per cent interest rate on special securities. This implied that immediately after this exchange, the annual cost to the Central Government and the annual income from the Reserve Bank would remain unchanged. The use of this security for sterilisation was expected to entail a cost to the Reserve Bank as in the case of earlier OMOs. In principle approval from the Finance Minister had been obtained for the proposal, the letter advised.

PROGRESS IN FISCAL CONSOLIDATION

Fiscal consolidation was the centre-piece of the comprehensive economic reforms launched in 1991–92 by the Government to restore the macroeconomic imbalance that had been severely disturbed.²⁶ Both the stabilisation of the BoP and control of rising inflation warranted an immediate and drastic reduction in the fiscal deficit. The regular Union Budget for 1991–92 (presented to Parliament on July 24, 1991) represented a major and conscious effort towards restoring fiscal balance, mainly by reducing the fiscal deficit by nearly two percentage points of GDP, *i.e.*, from 8.4 per cent in 1990–91 (RE) to 6.5 per cent in 1991–92 (BE and based on GDP projections at that time). However, it is worth noting that the Economic Survey for 1996–97 postulated that although it was relatively easy to say whether the trend in fiscal deficit was up or down, it was much more difficult to define the ‘appropriate’ level for each country at any given time in its stage of economic development.²⁷

The topic of fiscal adjustment was of critical concern and interest for the Reserve Bank in monetary management since unrestrained budget deficits would culminate in burgeoning public debt. In retrospect, fiscal consolidation and the accompanying financial sector reforms substantially scaled down the Centre’s dependence on net bank credit from the Reserve Bank and also the draft on the resources of the banking sector. The Governor, Dr C. Rangarajan, stressed that sustained fiscal adjustment must underpin further reforms and that, in the absence of credible fiscal control and price stability, there was some risk that interest rate deregulation could result in overshooting and, thus, disrupt the reform process.²⁸

The Reserve Bank, in its Annual Report for 1995–96, suggested that with the impending termination of the system of *ad hoc* Treasury Bills, the concept of the conventional budget deficit would have to be abandoned and the GFD formally used as the benchmark for assessing fiscal performance. While the components of the GFD would be along familiar lines, *e.g.*,

26. The topic of fiscal consolidation continues to be in the limelight even today.

27. Incidentally, the *Economic Survey, 1993–94* commented that a large fiscal deficit might have provided a useful expansionary counterpoise to the contractionary effects of financial sector reforms.

28. Rangarajan, C. (1994). “Developing the Money and Securities Markets in India”. Paper presented at the *Sixth Seminar on Central Banking*. International Monetary Fund. Washington, D.C., March 9.

indicating external and internal financing and within internal financing, market loans and non-marketable debt, a clear mechanism would have to be drawn up to indicate the sources of financing the GFD as between non-banks, banks and the Reserve Bank. The budget would then indicate the total recourse to the Reserve Bank by way of dated securities, Treasury Bills and other temporary accommodation. “The budget would need to present a figure on monetisation of fiscal deficit consistent with the objectives of overall monetary control,” emphasised the report.

Steady progress was made in reducing the GFD up to 1996–97, except for a setback in 1993–94, as can be seen from Table 15.3.

TABLE 15.3
*Gross Fiscal Deficit, Primary Deficit, Budgetary Deficit and
Monetised Deficit of the Central Government*

(As percentage of GDP at market prices)

Year	Gross Fiscal Deficit	Net Primary Deficit	Budgetary Deficit	Monetised Deficit
(1)	(2)	(3)	(4)	(5)
1990–91	8.33	3.35	2.12	2.75
1991–92	5.89	1.45	1.11	0.89
1992–93	5.69	1.65	1.74	0.60
1993–94	6.87	2.77	1.25	0.03
1994–95	5.56	1.16	0.09	0.21
1995–96	4.95	0.89	0.81	1.63
1996–97	4.73	0.64	0.94	0.14

- Notes: 1. Ratios for the period 1993–94 onwards are based on new GDP series (1993–94 = 100).
2. With the discontinuation of *ad hoc* Treasury Bills and 91-day tap Treasury Bills from April 1997, the concept of conventional budget deficit lost its relevance.
3. GFD is the excess of total expenditure including loans net of recovery over revenue receipts (including external grants) and non-debt capital receipts.
4. Primary Deficit means GFD minus net interest payments.
5. The conventional deficit (Budgetary Deficit) is the difference between all receipts and expenditure, both revenue and capital.
6. Monetised Deficit is the increase in net RBI credit to the Government, which is the sum of increases in Reserve Bank’s holding of central government dated securities, Treasury Bills, rupee coins and loans and advances from the Reserve Bank to the Centre since April 1, 1997, adjusted for changes in the Centre’s cash balances with Reserve Bank in the case of the Centre.

Source: Reserve Bank of India, *Annual Report*, various issues; *Handbook of Statistics on the Indian Economy*, 1999.

CHANGES IN FINANCING PATTERN

During the period from 1991–92 to 1996–97, fiscal consolidation was responsible for a compositional shift in the financing pattern of the GFD (Table 15.4), *i.e.*, the manner in which the Government financed its deficit. There was a perceptible shift away from captive sources of borrowing at below market rates towards market-related borrowings. The market borrowings were budgeted to finance 30.0 per cent of the deficit in 1996–97 (BE) as against 20.7 per cent in 1991–92. The budget deficit (conventional) displayed a mixed trend varying from a high of 30.6 per cent (1992–93) to 1.7 per cent (1994–95). The proportion of external finance in the financing of GFD was budgeted at 4.5 per cent in 1996–97 (BE), much lower than 14.9 per cent in 1991–92, but this was unrelated to the process of fiscal consolidation. The correlation between GFD and net RBI credit to the Central Government came down markedly in the 1990s, except for a sharp reversal in 1995–96 (Table 15.5).

TABLE 15.4
Financing of Central Government's Gross Fiscal Deficit
(Percentage)

Year	Internal Finance			Total (2+3+4)	External Finance	Grand Total (5+6)
	Market Borrowings	Other Liabilities@	Conventional Deficit*			
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1989–90	20.8	42.2	29.7	92.7	7.3	100.0
1990–91	18.0	49.5	25.4	92.9	7.1	100.0
1991–92	20.7	45.5	18.9	85.1	14.9	100.0
1992–93	9.2	47.0	30.6	86.8	13.2	100.0
1993–94	47.4#	26.0	18.2	91.6	8.4	100.0
1994–95	34.8#	54.6	1.7	91.1	8.9	100.0
1995–96	54.9#	28.3	16.3	99.5	0.5	100.0
1996–97	30.0#	45.8	19.7	95.5	4.5	100.0

Notes: # : Includes normal market borrowings, other medium and long-term borrowings and short-term borrowings (364-day Treasury Bills), from 1993–94 onwards.

@ : Other Liabilities comprise small savings, provident funds, special deposits and reserve funds.

* : Defined as variations in 91-day Treasury Bills issued net of changes in cash balances with the RBI. Up to March 31, 1997 this included *ad hoc* Treasury Bills support as well.

Source: Reserve Bank of India, *Annual Report*, various issues; Government of India, budget documents.

TABLE 15.5
Trends in Budgetary Deficits and Net RBI Credit to the Government

(₹ crore)

Year	Budgetary Deficit	Gross Fiscal Deficit (GFD)	Net RBI Credit to Government (NRBICG)	NRBICG as percentage of GFD
1989-90	10,592	35,632	14,068	39.5
1990-91	11,347	44,632	15,166	34.0
1991-92	6,855	36,325	5,168	14.2
1992-93	12,312	40,173	4,433	11.0
1993-94	10,960	60,257	851	0.1
1994-95	961	57,703	2,178	3.8
1995-96	9,807	60,243	19,871	33.0
1996-97	13,184	66,733	2,832*	4.2

Note: *: As per the RBI records after closure of government accounts.

Source: Reserve Bank of India, *Report on Currency and Finance; Handbook of Statistics on the Indian Economy*, various issues.

RESERVE BANK'S KEEN INTEREST IN FISCAL CONSOLIDATION

The Reserve Bank followed closely the Central Government's efforts towards fiscal consolidation and their results since they impacted both the efficacy of monetary management as well as the conduct of debt management operations. The central bank made known its views and perceptions on this subject through its Annual Report on several occasions.

In the initial stages of reform, the Reserve Bank expressed the view that fiscal correction at the Centre and in the states was long overdue if debt was to be kept within reasonable levels; as long as revenue deficits continued at the Centre and were financed by borrowing, the vicious cycle of increased borrowing and attempts to force banks to lend at below market rates would continue; and that the correction of the balance should focus on the basic flaw of the governments not balancing their consumption outlays with revenues, which was the root cause of disequilibrium.²⁹ The impact on market borrowing under the new system was expounded as follows:

The Government's medium-term objective of substantially reducing the Central Government's gross fiscal deficit has to be perceived in the context of ensuring that the level of domestic debt is kept within a sustainable limit. This is all the more necessary in view of the fact that the need to move towards market-related

29. Reserve Bank of India, *Annual Report, 1991-92*.

interest rates on Government dated securities and Treasury Bills is a pre-requisite for successful reform of the financial system as also to enable the pursuit of an effective monetary policy. While the Government's reliance on market borrowings has rightly been sought to be reduced, a word of caution is necessary in that the pace of reduction in market borrowing has to be consistent with the downward adjustment of the gross fiscal deficit. While reducing the market borrowing, care needs to be taken to ensure that the monetised deficit does not increase because of high cost of borrowing from other sources as this would be counterproductive to an early fiscal correction. At the same time, it is necessary to ensure that the system of financing the Government budget deficit is altered by an early date.

As far back as in 1991–92, the Reserve Bank had visualised that its accommodation should take the form of only WMAs to the Central Government up to an agreed level to be cleared at the end of each year, since excessive reliance on net RBI credit to the Centre resulted in considerable monetary instability. It even went to the extent of advocating a law restricting the extent to which the Centre could run a deficit and a legal ban on the government borrowing from all sources beyond a certain ceiling, with a sub-ceiling on borrowing from the Reserve Bank and the re-introduction of a CSF to redeem the public debt. The dilemma (as a result of the pressure on the overall borrowing programme in 1992–93 in the context of the policy decision for a phased reduction in SLR) was that the increase in coupon rates on government securities — a direct consequence of inflationary trends and the need to maintain a real interest rate — led to a problem for all borrowing entities, in particular, the states.

The sudden upsurge in the fiscal deficit during 1993–94 prompted the Reserve Bank to remark that containing fiscal deficit, and more particularly the revenue deficit, within moderate levels was essential in order to ensure that interest payments did not pre-empt a greater part of the revenue receipts.³⁰ More importantly:

The experience in relation to the market borrowing programme towards the end of the fiscal year 1994–95 and in the current year so far, highlights the problems faced in placing increasingly large amount of Government debt in the market. What the

30. Reserve Bank of India, *Annual Report, 1994–95*.

recent experience indicates is that there are limits to Government borrowing and there is a need to contain expenditures within what can be raised from the market at reasonable rates of interest. The need for pruning fiscal deficit becomes even more compelling in this context.

Finally, the Reserve Bank indicated that the problems of increasing debt and interest payments should be resolved on an urgent basis by having a more credible fiscal reform programme and placing a statutory ceiling on public debt. This should include the total liabilities of the Government; whereas the existing provisions of the Constitution of India placed a limit on public debt secured under the Consolidated Fund of India and precluded other liabilities. The Reserve Bank's Annual Report for 1996–97 contemplated that it was time to evolve a strong and qualitatively improved fiscal correction strategy, with the accent on achieving further compression in fiscal deficit along with a shift in the composition of expenditure in favour of crucial social and infrastructure sectors.

Even five years after the economic and financial sector reforms became an integral component of the monetary and credit policy framework as well as of the internal debt management policy, the Reserve Bank subscribed to the view that reduction of fiscal deficits was *sine qua non* for attaining the objective of fiscal and monetary stability. The Governor of the Reserve Bank reiterated that fiscal and monetary stability should be an important aim of any macroeconomic policy framework. Almost all the economic adjustment programmes involved, at the first instance, reduction of fiscal deficits and credit-induced expenditures, besides exchange rate shift to market levels. The idea of stability became relevant after addressing the immediate problems of the economic crisis. Even while undertaking drastic measures to overcome the crisis situation, countries sought to build on these to consolidate macroeconomic gains and to move to a position of stability.³¹

MARKET DEVELOPMENT STRATEGY

Debt markets were essential for financing economic activity. In India, debt markets basically comprised: (i) the government securities market, which was the oldest and most dominant; (ii) the public sector undertakings

31. Rangarajan, C. (1997). Address at the conference organised by the Wharton Economic Forum. Philadelphia. March 21.

(PSU) bonds market which developed since the late 1980s; and (iii) the corporate securities market.

The government securities market, the principal segment of the debt market, performed several crucial functions other than merely providing a means of financing government expenditure and that was why the governments issued securities even when they were in a comfortable surplus!³² A deep and liquid gilt-edged market emitted timely signals to the monetary authorities of the perceptions of the market regarding their expectations about economic activity and yields. Thus, it was pivotal in bringing about an effective and reliable transmission channel for the deployment of indirect instruments of credit control. More significantly, the government securities market provided the Reserve Bank with the instrumentality of conducting monetary policy through OMOs, which was the most flexible of the instruments of monetary policy. Finally, as a market for sovereign paper, the yield curve relating to the gilt-edged market served as a benchmark in the financial markets as a whole.

Apart from the Treasury Bills, government securities in a broad sense included term or dated securities of different maturities issued by the central and state governments and institutions guaranteed by these entities. They had an initial maturity in excess of one year and interest was usually payable by coupon. The size, maturity and coupon rates of these issues were being managed by the Reserve Bank. Government securities might not carry several of the typical risks attendant with corporate securities, but they did carry a risk that had to be managed well purely from the portfolio point of view.

The policy objectives relating to government securities market operations had been to smoothen the maturity structure of debt, enable debt to be raised at close to market rates and improve liquidity by developing an active secondary market. The first stage of reforms included the selling of government securities through auctions in a move to market-related interest rates on government paper, introducing new instruments such as zero coupon bonds, floating rate bonds and capital index bonds, introducing Treasury Bills of varying maturities, the conversion of Treasury Bills into dated securities, establishing specialised financing institutions, building a viable institutional framework centred on the PD

32. Rangarajan, C. (1996). Inaugural Address at the *Conference on the Government Securities Market*. STCI: Mumbai. April 6.

system and operationalising the DvP system of settlement to instil greater transparency in operations.

STAGES OF MARKET DEVELOPMENT

In the pre-Independence period (*i.e.*, prior to 1947), the government securities market had a relatively wide base with active secondary trading. However, in the 1950s, 1960s and 1970s, with the expansion of the market borrowing programme on a massive scale to finance the Five Year Plans, banks, insurance companies and PFs were statutorily required to invest in these securities. The average maturity of government securities remained fairly long — above 20 years — reflecting the preference of issuers rather than those of investors. The combination of a tightly controlled interest rate structure and statutory requirements to hold these securities deprived the secondary market of any vibrancy.

From the 1960s and just before 1990, the government securities market remained dormant, since the Government borrowed at pre-announced coupon rates from primarily a captive group of investors, namely, banks and insurance companies. They also happened to be the final investors in government securities, driven by considerations of statutory requirements. *Ipso facto*, this led to the conduct of a passive internal debt management policy. This, coupled with the system of automatic monetisation of the budget deficit, impeded the development of a deep and vibrant government securities market. Nevertheless, even within the framework of administered interest rates, the Reserve Bank made efforts during the second half of the 1980s to impart some flexibility to the money and government securities markets, based mainly on the recommendations of the Chakravarty Committee.

To encourage secondary market activity, the maximum coupon rate was raised in stages from 6.5 per cent to 11.5 per cent in 1985–86. Concurrently, the maximum maturity period was reduced from 20 years to 10 years. To develop breadth and depth in the market, the placement of 182-day Treasury Bills by auction, not rediscountable with the Reserve Bank, was introduced in 1986. The DFHI was set up in 1988 as a Reserve Bank subsidiary with participation from other money market institutions to help smoothen short-term liquidity imbalances and to impart greater flexibility to the money market.

With internal debt management transforming itself into a potent instrument of economic and financial sector reform, the Reserve Bank, in co-ordination with the Ministry of Finance, set in motion a series of policy

initiatives towards instrument development, institutional development and improving market transparency and efficiency with special reference to the secondary market.

TREASURY BILLS OF DIFFERENT MATURITIES INTRODUCED

Since 1992, the central government borrowings had been undertaken at market-related rates, primarily through auctions of government securities of different maturities. A new instrument of 364-day Treasury Bills through auctions was introduced in April 1992 that, along with 91-day Treasury Bills, widened the Treasury Bill market. This instrument became extremely popular and despite three large funding operations, the volume of outstanding bills remained high and was acclaimed as under:³³

The lesson from this experience was that if an instrument took into account the maturity preference of the market and there was a reasonable degree of liquidity for this instrument, the Government would be able to raise funds at reasonable rates of interest. Furthermore, there had been a basic degree of stability in interest rates on this instrument; while there were changes in interest rates on this instrument the changes had been extremely gradual. As the instrument did not suffer from volatility, it became very popular and was soon emerging as a reference rate in the system. The experience of the two and a half years was that the 364-day Treasury Bill had truly earned its place as a reference rate in the market for determining other rates in the system.

The method of auction for sale of government dated securities came into operation in June 1992 and for the sale of 91-day Treasury Bills in January 1993. Consequent to the primary market acquiring depth with market-related rates, some innovative instruments were introduced, *viz.*, conversion of auction Treasury Bills into term security, zero coupon bonds, tap stocks and partly paid stocks. With the discontinuation of *ad hoc* 91-day Treasury Bills from 1997–98, 14-day Intermediate Treasury Bills were initiated to enable state governments, foreign central banks and other specified bodies with whom the Reserve Bank had an arrangement to invest their temporary surplus funds. Funding of auction Treasury Bills into term securities at the option of holders turned out to be a successful

33. Tarapore, S.S. (1992). "Towards an Active Internal Debt Management Policy". Speech delivered at the *Seminar on Management of Government Securities*. Mumbai: UTI Institute of Capital Markets. October 10.

technique of debt management and gave a boost to activity in the secondary market.

INSTITUTIONAL DEVELOPMENT

With the primary market acquiring depth, the emphasis turned to building the institutional infrastructure. To activate the secondary market in government securities and PSU bonds, the STCI was set up in May 1994, which commenced operations in June 1994. It provided immediate liquidity to government paper and stimulated market-making activity by parties other than captive investors. Further, in order to strengthen the infrastructure of the securities market, improve secondary market trading, liquidity and turnover and encourage voluntary holding of government securities among a wider investor base, a system of PDs started operating from March 1996, with PDs offering two-way quotes with bidding commitments in the auction of dated securities and 91-day and 364-day Treasury Bills. In addition, to broaden the market with a second-tier dealer system and impart greater momentum in terms of increased liquidity and turnover, guidelines for satellite dealers (SDs) were issued in December 1996. Guidelines were issued on April 20, 1996 for the scheme of liquidity support to mutual funds dedicated exclusively to investments in government securities, either through outright purchases or reverse repos in central government securities outstanding at the end of the previous calendar month.³⁴

The impact of competitive pricing of securities was evident in shifts in the yield curve that reflected changing liquidity conditions and market expectations about interest, inflation and exchange rates. In a highly liquid market, the yields in the secondary market should anticipate the yields in primary issues. However, depending on the demand-supply balance in different maturities and the liquidity conditions in the system, the divergences between the two yields should be reasonably limited and credible. The trends in the preceding years showed that because of high liquidity in the secondary market for government securities of varied maturities, there had been a convergence between the secondary market yields and market expectations about the primary yield. This had also brought about a more efficient price discovery process.³⁵

34. This topic also finds a place in chapter 14: Monetary Management.

35. Rangarajan, C. (1997). "Activating Debt Markets in India". Keynote Address delivered at the *SBICAP Debt Market Seminar*. Mumbai. September 5.

IMPROVING MARKET TRANSPARENCY AND EFFICIENCY

The measures taken to strengthen market transparency and impart efficiency included: (i) introduction of the DvP System to ensure settlement by synchronising transfer of securities with cash payment — from July 1995 in dated securities and from February 1996 in Treasury Bills — and its extension to all PDOs by May 1996; (ii) publication from September 1994 of transactions in government securities recorded by the Reserve Bank under SGL accounts; (iii) changes in strategies of OMOs and repo auctions; and (iv) a larger percentage of mark-to-market valuation of investment portfolio of banks, namely, banks having to mark-to-market all their investments in a phased manner from 40.0 per cent to 50.0 per cent for the year ended March 1997.

STIMULATING SECONDARY MARKET DEVELOPMENT

A highly liquid and vibrant secondary market was a *sine qua non* for strengthening the primary issues market in government securities and also for the Reserve Bank to conduct active OMOs. There were close links between the development of the primary and secondary markets. Trading in liquid secondary markets helped to establish a market yield curve and to support a network of specialist traders in government paper, who could be engaged for the distribution of fresh issues.

Towards the close of the 1980s, the institutional structure of the secondary market was weak, because the predominant players belonged to the captive category and, therefore, had the same perceptions. Again, all the major players had more or less identical profiles and, hence, at any point of time were either all buyers or all sellers.

As mentioned earlier, the Reserve Bank made major efforts towards institutional development so that a two-way market with players with different perceptions emerged. The primary objective of setting-up a system of PDs and SDs was to enhance the distribution channels and encourage voluntary holding of government securities among a wider investor base, *i.e.*, increased depth and liquidity in the market. Further, in order to facilitate PDs and SDs in their objectives of trading and distribution of government securities, a scheme for availing of liquidity was made available to them. Second, the establishment of the STCI provided immediate liquidity to government paper and promoted market-making activity by other interested parties. Third, the Reserve Bank announced liquidity support for special dedicated gilt funds in April 1996. Fourth, banks were allowed

to freely buy and sell government securities on an outright basis and retail government securities to non-bank clients without any restrictions on the period between sale and purchase to promote retail market segment and to provide greater liquidity to retail investors. Fifth, deregulation of interest rates on government securities promoted an active secondary market. Sixth, the move to market-related rates of interest enabled the primary and secondary markets to send effective signals to each other. Seventh, to afford greater transparency in operations, the Reserve Bank: (i) began publishing from September 1994 details of transactions in government securities recorded by the Reserve Bank under its SGL accounts; and (ii) introduced an efficient electronic clearing settlement and depository system for transactions in government securities as also a system of DvP to reduce counter-party risk and risk of unauthorised diversion of funds through securities transactions. The commencement of operations by the National Stock Exchange (NSE) in June 1994 gave a fillip to trading in the secondary market. As a result of the initiatives taken by the Reserve Bank to activate the secondary market, an institutional structure with market participants of different interests and perceptions emerged, as also a transparent system of trading and a secured mechanism of payment and settlements.

The Reserve Bank discerned that while several measures had been taken to develop a secondary market, the liquidity in government securities continued to remain a 'vexatious' issue. Since the major players in the market also had the same perception, a two-way market could develop only if the investor base was diversified to include non-traditional segments, such as individuals, firms, trusts and corporate entities. The Reserve Bank resolved to take further steps in this direction.³⁶

'SWITCH QUOTAS'

There were two other changes in the securities operations. The first related to 'Switch Quotas'. A system of allotting annual 'Switch Quotas' had been prevalent since 1973, mainly to enable banks/institutions to improve the yields on their investments in government securities. Under the system,

36. These included liquidity support to gilt-edged funds, introduction of retailing scheme by banks, tap sales through the PDOs of the Reserve Bank, State Bank of India (SBI) and its associates and creation of a second layer of SDs. The Review of Internal Debt Management Policy and Operations for the period from November 1, 1994 to March 31, 1996: Memorandum to the Central Board of Directors, dated April 26, 1996.

an annual quota to each bank/institution was fixed for purchase of one loan against sale of another. After a review, the system was dispensed with from April 1, 1992, as it did not have any impact on monetary aggregates and was not consistent with the objective of developing OMOs as a tool of monetary policy. The Reserve Bank effected a change by offering for sale only a select number of securities that it wished to sell instead of including in its offer list all dated securities in its portfolio. Moreover, the Reserve Bank put on its purchase list certain securities for cash with a view to providing total liquidity to at least a few securities.

DEDICATED GILT MUTUAL FUNDS: TAX CONCESSIONS

With the objective of encouraging schemes of mutual funds dedicated exclusively to investments in government securities, the Reserve Bank decided to provide liquidity support. The guidelines for availing of such liquidity support were issued in June 1996. The Governor, in his letter dated June 18, 1996 to the Finance Secretary, requested the Government to provide tax incentives as well to unit holders in gilt mutual funds, reasoning:

I am fully aware that Government is generally of the view that it would be preferable to have a system of lower rates of income tax without concessions rather than higher rates of income tax with large concessions. In fact, the Government has slightly moved away from this approach when the concession of deduction from income under Section 80-L of the Income Tax Act was raised to ₹ 13,000. We face a difficult problem in relation to Government borrowing. Widening the investor base is very essential in this context and gilt Mutuals provide one means to reach individuals. This will also eliminate the problems of dealing in Government securities in scrip form by small retail holders. While raising the coupon rate is a straightforward way of making such paper attractive, it may not be appropriate at this stage because the Government bond rate serves as a bench mark rate in the market.

The specific proposal of the Reserve Bank was that income to unit holders arising out of investments in mutual funds exclusively dedicated to government securities up to ₹ 7,000 could be exempted from Income Tax; this exemption was to be in addition to the exemptions granted under section 80-L of the Income Tax Act. The letter added that it was preferable to provide the concession under section 80-L than under section 88, as the

amount invested in gilt mutual funds could be withdrawn after 46 days and there could be frequent in-and-out movements.

In early 1997, the Government opined that there was need to reduce the coupon rates on government securities, and conveyed this perception to the Governor during discussions on March 13, 1997. The Reserve Bank, however, dissented and postulated that a reduction in coupon rates on government securities would be possible only if the investor base was expanded by reaching individuals through retail.³⁷

TAX INCENTIVES TO INDIVIDUALS ON INCOME FROM GOVERNMENT SECURITIES

The Finance Minister, in his budget speech for 1997–98, proposed including gilts for the higher deduction limit of ₹ 15,000 under section 80-L of the Income Tax Act. In the memorandum on the Finance Bill, 1997, it was indicated that the Bill proposed to provide that any income by way of interest on any security of the Central Government or a state government would also be eligible for the additional deduction of ₹ 3,000 (section 80-L already provided for a deduction of ₹ 12,000 in the normal course and a further deduction of ₹ 3,000 on dividends from any Indian company and income received from units of UTI or approved mutual funds). The Reserve Bank reasoned that this proposal would not confer any additional benefit to savers to invest in government securities, particularly when a reduction in the coupon rate on government securities was being contemplated. Therefore, the letter strongly advocated that ‘having regard to the spirit’ of the Finance Minister’s speech and with a view to encouraging investment in government securities by individual investors, of the deduction limit of ₹ 15,000 under section 80-L of the Income Tax Act a deduction of ₹ 3,000 might be earmarked towards income on government securities and units of mutual funds exclusively dedicated to gilts.

BENEFITS OF GOVERNMENT SECURITIES MARKET REFORMS

In the initial stages the major focus of the reform was on the primary market, namely, a move to market-related rates of interest on government paper, introducing new instruments and strengthening the institutional framework. Perhaps the two most far-reaching steps were: (i) bringing

37. Letter from the Deputy Governor, Dr Y.V. Reddy, dated March 18, 1997, to the Finance Secretary, Shri Montek Singh Ahluwalia.

down the maximum maturity of government securities from 30 years in the early 1980s to 10 years and enhancing coupon rates; and (ii) placing limits on the use of the instrument of *ad hoc* Treasury Bills at artificially low rate of interest. The functioning of the government securities markets showed good improvement, which enthused the Reserve Bank to re-orient its monetary policy tools and bring down the level of government securities that banks were mandated to hold (*i.e.*, SLR). Also, the measures went a long way in deregulating interest rates and stimulating the development of the primary and secondary markets. Yet by 1996–97, the investor base was still not fully diversified to include non-traditional investor groups like individuals, firms, trusts and corporate entities.

The diversification of the investor base was important because only then could there be an active market in which the intent of investors to buy and sell was not in the same direction at various points of time. High expectations were placed on the role of the government securities market, *viz.*: “As one moves away from the present situation and envisages the architecture of the financial markets a few years down the line it is clear that the Government securities market will be the fulcrum for the monetary policy of the Reserve Bank of India.”³⁸

The 364-day Treasury Bill auction found ready acceptance in the market. Similarly, the 91-day auction Treasury Bill proved popular among market participants. The auctioned bills (91-day) were being absorbed almost entirely by the market and the rates emerging through competitive bids had become money market reference rates. In an encouraging development, some FIs introduced floating rate contracts linked to Treasury Bill rates. The 364-day and 91-day auction Treasury Bills were funded (1993–94) into dated securities of three-year and two-year maturity, respectively. These funded securities formed the basis of an active secondary market.

Turning to the government securities market, since the entire central government borrowing programme was conducted through auctions, it fostered an elastic band of interest responsiveness from investors for a range of maturities up to 10 years. This was an important step in the process of ‘price discovery’. There took place a major correction in interest rate disparities. To elaborate, revisions in coupon rates as also

38. Tarapore, S.S. (1996). “The Government Securities Market: The Next Stage of Reform”. Valedictory Address at the *Conference on the Government Securities Market*. Mumbai: STCI. April 6.

in the maturity structure of dated securities over a period brought these rates into better alignment with market terms, especially the prevailing lending rates of commercial banks. Despite relaxations in SLR, the market absorbed all primary issues without any significant devolvement on the Reserve Bank. A new treasury culture developed among banks and institutions. In an environment where new investors existed side by side with sophisticated institutions, the auction system within an administered framework enabled improved bidding skills among all market agents. Non-captive investors like FIs and the private corporate sector started showing greater keenness to acquire government securities. “Indeed, the accusation sometimes now made is that government securities yields are too attractive, and are responsible for keeping up the entire level of interest rates. In short, this experience provides an example of how market grooming combined with yield curve flexibility can take place even within an administered structure.”³⁹

In contrast to the past practice, the Reserve Bank showed its willingness to purchase certain securities for cash. It responded to market yields more quickly, using bidding patterns at its auctions as a guide. Depending on the term preferences of the market and the coupon rates, the Reserve Bank made selective offers to the market at competitive prices. This provided an instrument of yield-curve management even in the absence of a primary dealer network. It would be apt to conclude this narration with the following appraisal:⁴⁰

The groundwork has been laid to expand investor base gradually towards the non-traditional investors. Auctions have contributed to a new treasury culture and a progressive development of bidding and portfolio management skills among market agents. The yield curve has become flexible showing shifts according to market conditions and expectations. The increase in the secondary market activity combined with the improvements in payment and settlement system has brought about greater integration between money and capital markets and a better alignment of interest rates. The market aligned interest rates have enabled the Reserve Bank to

39. Rangarajan, C. (1994). “Developing the Money and Securities Markets in India”, Paper presented at the *Sixth Seminar on Central Banking*. Washington, D.C.: International Monetary Fund. March 9.

40. Rangarajan, C. (1996). Inaugural Address at the *Conference on the Government Securities Market*. Mumbai: STCI. April 6.

use active open market operations to partly sterilise the liquidity impact of foreign exchange inflows in 1993–94 and 1994–95.

SELECT POLICY ISSUES

Since the Reserve Bank acts as an agent for managing public debt, close consultations with the Ministry of Finance become necessary at almost every stage of planning and formulating policy and procedures (including the flotation of loans and Treasury Bills). This largely explains the time taken to streamline the procedures and implement reform measures. A few interesting issues that came up are sketched below.

CONSOLIDATED SINKING FUND

The tenth finance commission had recommended creation of a sinking fund to ease the burden of repayments. The Ministry of Finance desired to know the views of the Reserve Bank in July 1996. The Reserve Bank in a detailed letter dated July 31, 1996 saw merit in the proposal, but explained various difficulties in implementing the same.

At the outset, the Reserve Bank reminded the Government that all along it had been in favour of setting-up a CSF, having brought this to the notice of the Government some time earlier. While conceding that at a time when the Centre and the states were already facing a resource constraint, setting-up a CSF imposed a further burden and there was a general reluctance to take on any such additional burden at that time. The Reserve Bank submitted that the problem of repayment of debt had become ‘unsurmountable’ and unless early action was taken to address these problems, the fisc could progressively face serious difficulties. The Reserve Bank pointed out that giving up a CSF for states in the seventies did appear, in retrospect, to be unfortunate, since the existing system provided no arrangement for repayment of debt other than throwing it forward by larger borrowing. Moreover:⁴¹

Fiscal prudence, however, would require that the burden of repayment should be transparently reflected in the budget even if the Government is faced with a budget deficit. In the absence of a CSF, the present approach of gross borrowings to cover repayments would require gross borrowings to rise year after year

41. Letter from the Reserve Bank to the Ministry of Finance dated July 31, 1996.

and the interest burden would mount and sooner or later create a budgetary *impasse* which would then require drastic adjustment.

The Reserve Bank further stated that initially the CSF should be started on a relatively modest scale and there would need to be a sufficient gestation period before the CSF took on the repayment burden. According to the debt profile, the prevalent practice of gross borrowings meeting repayments would pose a more serious ‘bind’ on the Centre and the states. Therefore, there was merit in implementing the CSF concept for both these entities. “Postponing the introduction of a CSF till the fisc is in better balance would not be in the best interests of fiscal stability as the servicing of the public debt is itself a major factor accounting for the fiscal imbalance,” propounded the Reserve Bank. The Reserve Bank strongly recommended that a CSF be started from 1997–98 for both the states and the Centre. It was clarified that the CSF resources should be operated by the Reserve Bank and, hence, the CSF would purchase securities only from the Reserve Bank’s stock. If this procedure was followed, the Reserve Bank would ensure that the securities held by the CSF provided total liquidity as and when required for meeting the repayments and this would maximise the return on the corpus of the CSF, the letter averred.

SOVEREIGN BOND ISSUE

The Government sought the comments of the Reserve Bank on its going in for sovereign bond issues. Two main reasons were adduced. First, the sovereign bonds would establish a benchmark for sovereign country risk, enabling more successful bond issues by Indian corporate entities abroad as their bonds, with a sovereign benchmark, could be priced more objectively in international capital markets. Second, it would broaden the investment base and possibly supplement domestic borrowing requirement, given that there was going to be continuing requirement of long-term funds to finance infrastructure projects, on a substantially non-recourse basis. The Reserve Bank, after examining the suggestion, advised that taking into account the prevailing macroeconomic situation, the government should not go in for a sovereign bond issue and instead consider opening the government rupee debt market to FIIs (letter dated August 9, 1996). The reasons given were as follows:

- (i) The establishment of a benchmark for pricing Indian issues need not necessarily be through a sovereign bond. All issues by the corporate, including quasi-government agencies, were then being

cleared by the Government of India and the Government had a certain amount of manoeuvrability in the pricing of issues. A sovereign issue would jeopardise the prospects of borrowing by other Indian entities at fine rates.

- (ii) A single sovereign issue could not establish a benchmark. This would need to be repeated at periodic intervals and in different markets. Such large volumes of issues had to be weighed against critical considerations of debt management, such as cost effectiveness and exchange risk exposure.
- (iii) The cost of Government's domestic borrowing for a 10-year maturity was around 14.0 per cent. For an international bond issue of similar maturity, the coupon rate could be around 200 basis points over the US treasuries, *i.e.*, around 9.0 per cent. This implied that to be cost-effective the exchange risk should not exceed 5.0 per cent and this might not be realistic.
- (iv) Although there was a large demand for funds for infrastructure, the current policy favoured inflows through foreign direct investment (FDI) rather than debt creating flows.
- (v) The experience of project financing even with government guarantees was that foreign investors preferred project-tied lending with specified amortisation schedules and special arrangements, such as escrow accounts. Therefore, it would be better for the Government to guarantee such project-specific bond issues by sectors like infrastructure rather than directly issuing government debt denominated in foreign currency.
- (vi) From the angle of properly sequencing the debt management policy measures, even the rupee debt of the Government was not open to foreigners including the FIIs. It would be prudent in the initial stages if the rupee debt market was opened up to the FIIs before embarking upon sovereign debt issues abroad. This had been the sequencing followed by the East European countries, Thailand and South Africa.
- (vii) Institutional investors (pension funds, mutual funds and insurance funds) allocated a certain proportion of their portfolio exposure to a particular country, irrespective of whether the issuers were private bodies or the governments. Considering this investor profile abroad, there was not much scope for immediately enlarging the share of Indian issues in the international market.

FIIs INVESTMENTS IN GOVERNMENT SECURITIES

The Government decided on January 30, 1997 to permit FIIs in the category of 100.0 per cent debt funds to invest in government (central and state) dated securities in both the primary and secondary markets. The objective was to encourage further flow of foreign capital into the Indian capital market and help bridge the gap between domestic savings and investment in a more cost effective manner as also to provide greater depth and liquidity to the government securities market. The Reserve Bank issued guidelines on March 8, 1997 prescribing the manner of FII investment in government securities.

For the purpose of FII investment, government dated securities included dated securities of both the Government of India and state governments of all maturities, but not Treasury Bills. Investments by FIIs could be undertaken only through designated banks. Secondary market transactions by FIIs would be permitted through recognised Indian Stock Exchanges or over-the-counter with SGL account holders and would be covered by the DvP system of the Reserve Bank.

This liberalisation was the result of a drawn-out correspondence with the Government, which, in the main, pertained to the broader canvas of encouraging investment in government securities by non-residents. In November 1995, the Reserve Bank took the initiative by broaching the subject of permitting FIIs in dated government securities. The Governor, Dr C. Rangarajan, in his letter dated November 4, 1995 to the Finance Secretary recalled that the question of allowing FII investment in government securities had been discussed in the high level capital market committee meeting, but a decision was deferred. He opined that the time was appropriate for a decision in the matter. "Given the high level of requirement of the Central Government in the current year and the difficulties faced in raising funds, my view is that we should permit FIIs to invest in the Government dated securities market subject to the condition that the FIIs will not be allowed to sell these securities in the secondary market for a minimum period of six months after acquisition. The earlier concern that such an opening will lead to a large inflow of funds appears unlikely under the present market conditions," the Governor elaborated.

In the same letter, the Reserve Bank pointed out an anomaly that whereas non-resident Indians (NRIs) were allowed to invest in government securities, they were not permitted to participate in auctions for primary issues of government securities. It was considered desirable to allow NRIs also to participate in government dated securities' auctions, as this would

obviate the criticism that NRIs were placed in a less-favoured position than FIIs. The Reserve Bank further suggested to the Government to consider separately whether FIIs could be allowed also to have 100.0 per cent debt funds rather than be subject to the existing 30.0 per cent ceiling on investments in debt instruments.

While on this topic, it may be mentioned that in September 1993 the Government had requested the Reserve Bank (in a letter dated May 11, 1993 from the Chief Economic Adviser) to work out 'schematic' details regarding the broadening of the government securities market by allowing non-residents to participate in primary and secondary market investments in government securities. Within the Reserve Bank, after examination of the issue and discussion among the officials, it was decided that certain relaxations could be suggested to the Government. First, in addition to the investment opportunities available to NRIs (including bodies predominantly owned by NRIs) and FIIs, non-resident foreigners might be permitted to invest in government securities including Treasury Bills on a repatriation basis through authorised dealers (ADs)/FIIs. There would be no exchange rate guarantee. Second, investment in government securities including Treasury Bills by non-residents and FIIs would be subject to an overall ceiling of 30.0 per cent on investment in debt instruments including debentures. Third, investment by non-residents and FIIs in central government securities including Treasury Bill auctions would be on a 'non-competitive' basis. Investments in state government securities and tap Treasury Bills would be on application.

SALIENT ASPECTS OF STATE FINANCES

The quality of fiscal adjustment also depended on the fiscal initiatives at the state level. The rising level of state revenue deficits and a high order of implicit subsidy offered little scope for improving the states' financial health and enlarging their development role in the economy. The resources of the states were under severe strain in 1996–97 as revealed by the frequent resort to overdrafts with the Reserve Bank by several of them. The strain on the states' resources had adverse implications for social allocations and development outlays. The revenue deficit of the states increased from an average of 0.3 per cent of GDP during 1985–1990 and 0.7 per cent during 1991–1996 to 1.2 per cent in 1996–97; however, it was expected to be restricted to 0.9 per cent in 1997–98. As a result, capital expenditure (comprising direct capital outlays and loans) of the states suffered a sharp cut, with its ratio to GDP declining from 3.2 per cent during 1985–1990 to

2.5 per cent during 1991–1997. Much of this cut took place in the critical social and infrastructure sectors, which had a bearing on the long-term growth prospects of the economy.

A general characteristic of the state budgets was their structural weakness in the form of large revenue deficits, rising interest burden, increased distortions in expenditure pattern and small growth in non-tax revenues. One fundamental weakness in their finances was the quantum jump in non-development expenditure, particularly in its revenue component, and interest payments as a proportion of revenue receipts.

The consolidated position of the state government budgets showed large budgetary gaps, particularly on the revenue account, and increased reliance on market borrowings as well as on loans from the Centre (Table 15.6). Consequently, the large repayment obligations to the Centre were expected to absorb a substantial and growing proportion of fresh loans, while the continued recourse to market borrowings at higher coupon rates and shortened maturity pattern might result in increased interest burden and the bunching of repayment obligations in the medium-term.

TABLE 15.6
*Gross Fiscal Deficit, Revenue Deficit and Market Borrowings of
State Governments (Consolidated)*

(₹ crore)

<i>Fiscal Year</i>	<i>Gross Fiscal Deficit</i>	<i>Revenue Deficit</i>	<i>Market Borrowings (net)</i>
(1)	(2)	(3)	(4)
1989–90	15,433	3,682	2,298 (14.9)
1990–91	18,787	5,309	2,556 (13.6)
1991–92	18,900	5,651	3,305 (17.5)
1992–93	20,892	5,114	3,500 (16.8)
1993–94	20,596	3,813	3,620 (17.6)
1994–95	27,697	6,156	4,075 (14.7)
1995–96	31,426	8,201	5,888 (18.7)
1996–97	36,167	15,555	6,350 (17.6)

Notes: 1. Figures in brackets are percentages to GFD.

2. Revenue Deficit denotes the difference between revenue receipts and revenue expenditure.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 1999; Annual Report, 1996–97.*

The Reserve Bank in its capacity as banker to state governments, offered its perceptions about the condition of their budgetary finances in its Annual Reports, the gist of which is presented here. A view was expressed

that the existing mechanism of market borrowings from the viewpoint of conformity with the on-going financial sector reform needed a review. A system had to be evolved under which it might be possible for financially sound states to access funds at market rates, while ensuring a stipulated level of borrowings in the case of less developed states. In its Annual Report for 1993–94, the Reserve Bank observed that the structural aspects of state government finances underscored the need for fiscal reforms primarily aimed at phasing out their revenue deficit and it was advisable for the state governments as a group to initiate budgetary reforms to improve the efficiency of resources, *viz.*, by reducing the size of non-Plan non-development expenditure and augmenting the revenue base. Again in the 1996–97 Annual Report, the Reserve Bank averred that the quality of fiscal adjustment would improve considerably if there were enough fiscal initiatives at the state level as well, and reiterated that balancing the revenue accounts of states in a medium-term horizon through tax reforms as well as re-orientation and reduction of subsidies should constitute an essential element of overall fiscal reform.

WAYS AND MEANS ADVANCES AND
OVERDRAFTS FROM THE RESERVE BANK OF INDIA

The aggregate sum of WMA provided by the Reserve Bank to 23 states to tide over temporary gaps in their cash flows remained unchanged at ₹ 744.8 crore in 1990–91, 1991–92 and 1992–93. Likewise, the special WMA given to these states against the pledge of central government securities remained at ₹ 266 crore during these three years. During 1990–91 and 1991–92, all the state governments complied with the overdraft regulation scheme, 1985, under which any overdraft had to be cleared within the stipulated period of seven working days. However, in 1992–93, a few states could not comply with the above stipulation and the Reserve Bank had, therefore, to stop payments on behalf of these state governments until the overdrafts were cleared. Similar action was taken during 1993–94 when one state government could not clear its overdraft within the specified time frame.

Despite the enhancement of the WMA limits from November 1, 1993 (to 84 times and 32 times of their minimum balances in the case of normal and special advances, respectively) as well as the extension of the time limit to clear overdrafts (to 10 consecutive working days), some state governments frequently resorted to overdrafts during 1994–95, probably due to their unsatisfactory liquidity management. Certain state

governments were unable to clear their overdrafts within the specified time limit on eight different occasions and, therefore, the Reserve Bank stopped payments on their behalf until the overdrafts were cleared. It was the same case with a few state governments in 1995-96.

To alleviate the problems faced by state governments, the Reserve Bank doubled the existing normal limits for WMA to ₹ 2,234 crore and of the special WMA to ₹ 851 crore from August 1, 1996. State governments were not expected to treat the WMA as a liquidity management device or as a perpetual financing item. There was a marked deterioration in the liquidity management of the state governments during 1996-97 emanating from the aggravation of structural imbalances in their finances, as reflected in the downturn in the major deficit indicators. Eight state governments frequently resorted to overdrafts; one of them could not clear its overdrawn account with the Reserve Bank within the stipulated limit of 10 consecutive working days and payment had to be stopped on behalf of that state government. What perturbed the Reserve Bank (as brought out in its Annual Report for 1996-97) was that the sharp deterioration in the liquidity position of the state governments came about despite the enhancement in the WMA limits from August 1, 1996. Simultaneously, the interest rate structure in respect of the Reserve Bank's advances was rationalised, with the Bank Rate being made applicable to the shortfall in the minimum balance and availment of WMA and a rate of 2.0 per cent above the Bank Rate for overdrafts. This rationalisation was expected to have a moderating effect on the interest payment obligations of the states.

CONCLUDING OBSERVATIONS

In the long run, the macroeconomic consequences of public debt are dependent on the volume of its growth in relation to nominal GDP growth, the extent of increase in private savings in absorbing the additional public debt and the impact of public debt on the monetary situation. The condition for stability of the debt-GDP ratio implies that the real interest rate must be lower than the growth rate of output, which ensures its convergence to a stable value in the long run. However, the more immediate concerns for policymakers in respect of a high level of debt-GDP ratio are its interest burden, the 'crowding out' of productive outlays, the higher proportion of private savings being absorbed by the Government, the pressures on the interest rate and more importantly the monetisation of debt.

From 1992, a number of structural and institutional changes were brought about. These included the reform in the government debt

markets, which ultimately facilitated the introduction of the WMA scheme to the Central Government in April 1997. For the Reserve Bank, in its conventional role as debt manager to the Government, the annual exercise of monetary projections for the market borrowing programme became a cardinal means of communicating to the Ministry of Finance at the highest level its own assessment of the balance of forces operating within the economy as the latter decided on the design and thrust of fiscal policy in the budget formulation. There evolved a general recognition among the monetary and fiscal authorities that a qualitative fiscal adjustment would, in the long run, enhance the scope for greater flexibility in the conduct of monetary policy and increase the confidence in proceeding with the financial sector reforms.

As a pre-requisite to developing an active government securities market, the Reserve Bank took measures to fashion market clearing rates of interest on government securities. This provided a strong benchmark for other interest rates and ensured that debt was priced correctly in the entire financial system. More importantly, market orientation to issues of government securities paved the way for the Reserve Bank to activate OMOs as a tool of market intervention. For the government securities market to remain active and possess depth, trading in securities should be highly liquid, which again called for an active secondary market. The establishment of the DFHI fostered an active secondary market, first in Treasury Bills and subsequently in government dated securities. The main task of the STCI, which was set up in 1993, was to develop a secondary market in government dated securities and public sector bonds.

Ever since the late 1980s, Treasury Bills, which were a short-term financing instrument of the Central Government, played a proactive and catalytic role in public debt management. The 91-day Treasury Bills were in the main held by the Reserve Bank at a very low discount rate of 4.6 per cent. With a large overhang of these bills, the authorities were reluctant to move up the rate for this instrument to a more realistic level. More disturbingly, under the administered structure of interest rates, the Treasury Bill rate was the lowest in the system. In a major policy departure, 182-day Treasury Bills were introduced on auction basis and the rate of interest was close to market trends. With the objective of reducing monetisation of public debt and developing the government securities market, the auction system was adopted for 91-day and 364-day Treasury Bills (in April 1992) as in the case of dated securities.

The auctioning of government securities obviated the need for recourse to borrowing from the Reserve Bank. From the perspective of macro monetary management, the evolution of a truly active system of internal debt management served as a strong impetus for a shift in monetary policy strategy from the use of direct instruments of monetary control (*i.e.*, reserve requirements, administered interest rates and selective credit controls) to indirect instruments (*i.e.*, OMOs, repo transactions and interest rates). Special mention should be made of the introduction of repo auctions in government securities and a fresh approach to pricing of these securities for secondary market operations. Relations between the Reserve Bank and the Government were bolstered consequent to the phased elimination of automatic monetisation of the budget deficit through the issue of *ad hoc* Treasury Bills. There took place timely and systematic exchange of information on macroeconomic developments and assessments thereon between the central bank and the Ministry of Finance in framing and operating in conjunction monetary policy and debt management policy.

Nevertheless, the Government's increased recourse to borrowing from the market exerted pressure on interest rates, and triggered concomitant policy responses to minimise the cost of borrowing by placing a large part of borrowings at the shorter end of the market. This compressed the average maturity and gave rise to the problem of debt roll-overs. As a consequence, the share of shorter maturities (*i.e.*, under 5 years) in total outstanding market loans rose five-fold, from 7.4 per cent as at the end of March 1992 to 38.4 per cent at end-March 1996. The shorter maturity loans constituted almost 50.0 per cent of the total market loans raised by the Central Government during 1996–97.

The series of policy measures taken to strengthen public debt management by the Reserve Bank in co-ordination with the Government keeping the structural aspects in view during the eventful years from 1991–92 to 1996–97 had beneficial effects on the system in terms of greater market absorption of government securities, lower devolvement on the Reserve Bank, competitive pricing of securities, emergence of a market-responsive yield curve and increased attention accorded to treasury management and interest rate risk management by bankers and investors. On the part of the Reserve Bank, the main challenge was in the pursuit of a strategy for elongating the maturity pattern of outstanding government debt to reduce the refinancing risk by lessening uncertainties in financial markets and widening the range of maturities.

ANNEX I

*Progress in Strengthening the Government Securities Market
(1992–93 to 1996–97)*

I. GOVERNMENT SECURITIES

- (i) The entire central government borrowing programme in dated securities conducted through auctions from April 1992.
- (ii) Government securities refinance facility introduced at 14.0 per cent.
- (iii) 5-year, 6-year, 7-year and 10-year securities sold through auctions.
- (iv) Maturity period of new issues of central government securities reduced from 20 to 10 years. Maturity of state government securities shortened from 15 to 10 years.
- (v) Ceiling interest rate on dated securities raised from 11.5 per cent (20-year) to 13.0 per cent (15-year).
- (vi) Five new instruments introduced, namely, zero coupon bonds on January 18, 1994, tap-stock on July 29, 1994, partly paid government stock on November 15, 1994, another instrument, combining the features of the tap-stock and partly paid stock on September 11, 1995 and floating rate bonds on September 29, 1995.
- (vii) Guidelines for PDs in the government securities market issued in March 1995.
- (viii) Dedicated mutual funds for gilt-edged securities.

II. TREASURY BILLS

- (i) 364-day Treasury Bills sold by fortnightly auctions from April 1992. Sale of 182-day Treasury Bills discontinued.
- (ii) Auction of 91-day Treasury Bills commenced in January 1993.
- (iii) Funding of auction Treasury Bills into fixed coupon dated security at the option of holders introduced from April 19, 1993.
- (iv) State governments and eligible PFs allowed to participate in 91-day Treasury Bill auctions on a 'non-competitive' basis from August 1994.
- (v) Funding of Treasury Bills into dated securities introduced through auction mechanism in April 1995.

III. OPEN MARKET OPERATIONS/REPOS

- (i) Introduction of repurchase obligations (repos) auctions collateralised by central government securities (December 1992) — a precursor to active OMOs.
- (ii) The system of 'Switch Quota' for banks and FIs discontinued from April 1992 as they did not have any effect on monetary aggregates.

- (iii) A scheme for auction of government securities from Reserve Bank's own portfolio as part of its OMOs announced in March 1995.
- (iv) Reserve Bank offered a select list of securities, depending on supply and demand conditions, instead of offering for sale most of the securities in its portfolio.
- (v) Reverse repo facility with the Reserve Bank in government dated securities extended to DFHI and STCI. The earlier refinance facility to these institutions for such securities was withdrawn. Refinance facility against Treasury Bills, however, continued.

IV. GREATER TRANSPARENCY IN SECURITIES TRANSACTIONS

- (i) Details of transactions in government securities put through SGL accounts with the Reserve Bank being published from September 1994.
- (ii) A system of DvP in SGL transactions introduced in Mumbai in July 1995.
- (iii) Changes in accounting and valuation norms for banks' investments in government securities, *i.e.*, increase in the level of marking to market from the year ended March 1997.

V. INSTITUTIONAL INFRASTRUCTURE

- (i) IDMC set up in the Reserve Bank in April 1992 to initiate active debt management operations.
- (ii) STCI set up in June 1994.
- (iii) A system of PDs (March 1996).
- (iv) Guidelines issued for SDs system in government securities market.
- (v) DFHI strengthened its presence in the government securities market.

ANNEX II

IMF Monetary and Exchange Affairs Department
India: Development of the Government Securities Market
Mr Sergio Pereira Leite and Others⁴²

At the invitation of the Reserve Bank of India, an advisory mission from the Monetary and Exchange Affairs Department of the IMF visited India in 1992 to propose measures to foster government securities market in India and allow the Reserve Bank to use OMOs as a major instrument of monetary policy. This mission was headed by Mr Sergio Pereira Leite and submitted its report in July 1992.

The mission suggested various measures aimed at providing the Reserve Bank with the instruments and internal structure needed to conduct OMOs; establishing a market structure for government securities which would be conducive to liquidity and efficient pricing in that market, and improving public debt management practices. The mission indicated its preference for a swift liberalisation of all interest rates, along with an accelerated move towards elimination of market distortions. At the same time, the mission recognised that budgetary considerations required the liberalisation process to be undertaken in the context of the adjustment programme.

As a minimum, the mission recommended five important measures, as follows:

- (i) The placement of Treasury Bills should be carried out on a competitive auction basis. The Reserve Bank should not participate at the auctions, but instead purchase securities from the secondary markets. Detailed results of every auction should be made public.
- (ii) The Reserve Bank and the Government should allow the interest rates on Treasury Bills to rise to levels consistent with competing instruments in the money market.
- (iii) The 364-day Treasury Bill should be used as the main instrument for monetary policy purposes, as well as a key funding instrument for the Government. In particular, the mission was not in favour of the issue of new 91-day Bills at the moment, but rather market attention should be focused on a single instrument.
- (iv) Repurchase agreements could be a major financial instrument that, contrary to popular belief in India, could reduce risks in the banking system, rather than increase them. Therefore, repurchase agreements between banks and other government securities dealers should be

42. Note on *Issues in Developing the Government Securities Market and Open Market Operations in Support of Financial Sector Reforms*. Prepared by the IMF Advisory Mission to Study the Government Securities Market in India. Headed by Mr Sergio Pereira Leite. July 1992.

encouraged rather than condemned. Repurchase agreements with all interested parties, banks and non-banks should also be permitted as soon as the PDO book-entry system is improved, the RBI sets clear prudential rules for authorised dealers and puts in place mechanism to enforce these rules.

- (v) The SLR and CRR should be reduced as fast as conditions permit, and they should be based on banks' average positions over some period.

Open Market Operations

The mission averred that OMOs were a flexible instrument of monetary policy. As such, they were gradually becoming the monetary instrument of choice in industrialised and developing countries alike. However, in order to derive the full advantages of the use of open market policies, a few key conditions were needed to be in place. These included interest rates to be market-determined, the financial market should be relatively competitive and free of excessive market segmentation and the central bank should have the means to undertake open market policies and necessary internal structure that would allow it to intervene in the market purposefully and efficiently.

In order to effect OMOs on a day-to-day basis, the Reserve Bank would need three elements: (i) a market instrument that could be used for intervention; (ii) up to date information on market developments and good forecasting capabilities on money market developments and liquidity; and (iii) an adequate institutional set up at the Reserve Bank. The following recommendations applied to Reserve Bank's operations relating to open market policies:

- (i) The Reserve Bank should use repurchase and reverse repurchase agreements with securities dealers as its main open market policy instrument. Outright sales and purchases of Treasury Bills could also be used in cases where a reversal of the arrangement was not expected in the near future. The 364-day Treasury Bill would be the main security used in these transactions.
- (ii) In order to separate monetary policy from 'on demand' government financing, the mission recommended that the Reserve Bank should stop accepting *ad hoc* Treasury Bills. Temporary financing of the Government could be achieved through repo auctions, using Treasury Bills placed on a SGL account by the Government, but managed directly by the Reserve Bank. Until the Reserve Bank was ready to implement this recommendation, the issuance of Treasury Bills on an *ad hoc* basis should be limited and the yield on these bills should be raised to market levels. No additional 'special securities' should be created as these assets were arbitrarily priced and entirely non-marketable.
- (iii) The Reserve Bank should develop its capacity to monitor market conditions, and to forecast liquidity over the short term, if it was to intervene in a purposeful manner.

- (iv) The Reserve Bank should consider establishing an open market committee that would meet, say, once every two weeks to review monetary conditions and decide on the detailed direction of open market policy. Policy would then be carried out by a dealing room, supported by a back office, by requesting quotes from dealers and carrying out transactions.

Thus, emphasis was laid on a market instrument that could be used for intervention, up to date information on market developments and good forecasting capabilities on money market developments and liquidity and an adequate institutional set up at the Reserve Bank (*i.e.*, money market desk, and open market committee). The report observed:

The RBI seems to be experienced in financial forecasting over longer horizons. Forecasting liquidity from week to week or day to day is conceptually similar. Inputs from many sources need to be assembled to predict the major sources of variations in bank reserves. The Government itself, as the largest agent in the economy, can often disturb markets through its large transactions, be they regularly timed, such as salary payments or exceptional, such as payments for “big ticket” capital goods. Under these circumstances, the need for short-term government cash flow forecasts should be clear. The foreign exchange market can often provide at least a day’s warning on major transactions because settlement takes at least two days. Indeed, day-to-day forecasting is normally easier than forecasting over somewhat longer horizons.

*Institutional Structure of the
Government Securities Market*

The development of a vibrant, deep and broad government securities market is an important objective of the Reserve Bank reforms: to carry out monetary management through OMOs and debt management through an auction programme. Attainment of this objective would be facilitated by a transparent market structure that had well-specified roles for each participant and operated in a well-supervised and regulated environment. In structuring the market, the micro-objectives were to (i) formalise the role of various market participants; (ii) establish an underwriting capability to support primary auctions of government securities and OMOs; (iii) centralise market information on prices, quantities and trading in money market and dated securities market operations; (iv) standardise market trading practices in money market instruments, debentures and government securities; (v) create a competitive framework for dealers in government securities; and (vi) establish a regulatory and supervisory framework for the government securities market.

The preferred structure of the government securities market was to be three layered, namely, government securities dealers, PDs and inter-dealer brokers. End-investors would purchase government securities through dealers. This structure was expected to achieve the best balance between competition and the need to concentrate demand and information.

Improvement in Public Debt Management

The mission believed that improvements in the practices of public debt management would not only encourage the securities market but also contribute to minimising the cost of government funding. Moreover, the long-term development of the securities market was considered an essential part of the reforms, especially because the traditional securities market investment was diverted into non-marketable debt. In this regard, certain recommendations were made on public debt management, namely, the Government should not lock itself into high debt servicing costs by issuing very long-dated securities, auctions should be the normal funding mechanism, new issues should be concentrated in a smaller number of securities that could act as benchmarks at various representative maturities and the procedures of the PDOs should be improved and its operations computerised immediately.

In the aftermath of the securities market scam, the mission noted that the PDO (the existing system in the Reserve Bank for clearing securities transactions) suffered from a number of problems. Although ordinarily transactions were cleared in a day, in some periods such as around banks' 'make-up' day, clearing could take up to 10 days and many orders were rejected because the seller lacked the securities. Credit advices were sent with a 10-day delay and statements were sent only half-yearly. The system for settling transactions in other securities also needed improvement. Improvements in the functioning of the PDO would contribute to the information flow in the market and to the safety of the system. The mission fully supported the recommendation in the interim report of the Janakiraman Committee that reporting by the PDO needed to be improved and its work computerised immediately.

The report admitted that the Government was implementing a challenging programme of fiscal consolidation and therefore the extra costs relating to higher, market-determined interest rates came at a difficult time. But the mission was of the opinion that this was a worthwhile investment in the efficiency of the economy as a whole, and in the effectiveness of monetary policy.

STRATEGY FOR ACTIVE DOMESTIC PUBLIC DEBT MANAGEMENT

According to the report, the Government faced a major task of public debt management in meeting both its gross funding needs (including the refinancing of treasury bills and other maturing securities) and in ensuring that it would be in a position to secure funding at reasonable cost in the future. It was, therefore, necessary to develop a strategy for active public debt management in India. The mission considered that the essential element of such a strategy was the improvement in the depth and liquidity of the market in government securities. To this end, it would be necessary to offer competitive market-related yields on government securities, thereby inducing into that market a wider spectrum of players. The strategy envisaged was:

Harnessing these divergent sources for government funding in an orderly and efficient manner will require not only competitive yields, but also drastic improvements in the management, functioning and efficiency of the primary and secondary markets in government securities. In this context, particular regard must be paid to the optimal duration of the Government's stock of securities, the issuance procedure, and avoiding a proliferation of new issues; extension of the auction system and development of the secondary market...⁴³

SECOND IMF MISSION (APRIL 1993)

As a follow-up to the Leite mission, a second mission from the IMF visited India in March 1993, led by Mr William E. Alexander. Its task was more specific, namely, to make recommendations for the establishment of an appropriate market infrastructure, especially in the areas of clearance and settlement systems for government securities, and regulation and supervision of the government securities markets. At the same time, the mission was asked to consider measures that might be implemented in the near term to resuscitate activity in the public sector undertakings (PSU) bond market. However, the mission was unable to complete its assignment due to bombings that occurred at the end of the first week of its stay in Mumbai. The mission therefore submitted an incomplete report in April 1993 that 'at best could be regarded as being in the nature of a progress report whose conclusions and recommendations must be regarded as tentative'. The proposals to resuscitate the PSU bond market are not covered here.

Adverting to the earlier report of the Monetary and Exchange Affairs Department (July 1992) for adoption of a PD system as the market form for trade in government securities, the Alexander Committee considered alternative market forms. These were auction markets, dealer markets, and combination and hybrid markets. It came round to the view that when the conditions for an auction market were not met, including natural liquidity, a dealer market was likely to be the most appropriate choice. In such a system, dealers played an active role in the secondary market by generating secondary market trading, appropriately pricing the security, absorbing the order flow, distributing the security and educating the investor base. Further, it strongly suggested that the microstructure of a dealer market was superior to that of the auction market for government securities, because, in the case of India, it was likely to take a number of years to develop sufficient distribution of government securities to provide the degree of natural

43. The Reserve Bank apprised the Ministry of Finance in November 1992 of the main recommendations of the IMF Mission Report. The latter, in turn, proposed in February 1993 setting-up a Co-ordination Committee with participation from the Ministry of Finance and the Reserve Bank to co-ordinate debt management and monetary policy issues, which, however, did not find favour with the Reserve Bank. More details on this issue are given in chapter 14: Monetary Management.

liquidity that was needed to drive an auction market. Of the two practical options for the choice of the primary dealer market form, namely, the PDM and the Over-the-counter Exchange of India (OTCEI), the mission felt that an active role by the Reserve Bank in the development of a competitive PDM⁴⁴ in government securities would lead to an efficient market for government securities in a shorter time than envisaged under the parallel development of the OTCEI and the NSE. Two additional reasons were adduced to favour the development of PDMs. First, because the number of banks and FIs that invested in government securities was small and individuals did not normally invest in government securities, all current investors would wish to become PDs and would likely qualify. Thus, PDs and final investors would likely to be the same, reflecting the captive nature of the market. However, looking to the future when government securities would be more widely held and provide the foundation for the capital market in India, it could be assumed that individuals and non-bank FIs (notably mutual funds) would become investors in government paper without, at the same time, wishing to become market-makers. Others might wish to deal in government securities by distributing them to retail investors, again without wishing to develop the expertise or employ the capital necessary to become a market-maker. The result was that a distinct role for a PD would emerge. Second, it was important for the central bank to encourage the development of a market form that would be conducive to the future conduct of active OMOs. The PDM offered clear advantages, which was evident from the almost exclusive reliance by industrialised countries' central banks on this particular market form. Finally, the mission strongly recommended the inter-dealer market (rather than OTCEI, where inter-dealer direct trading took place) as it could promote price discovery, act as an information intermediary by reducing search costs to determine the best price for a security and promote liquidity in the market. The mission believed that developing the PDM to include inter-dealer brokers would add significantly to the dynamic efficiency of the market and reduce systemic risk.

44. PDM: Primary Dealers' Market.

ANNEX III

STATEMENT 15.1

Domestic Liabilities of the Government of India (As at End-March)

(₹ crore)

<i>Item</i>	<i>1991</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>
<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	<i>(4)</i>	<i>(5)</i>
Internal Debt (i to viii)	1,54,004	1,72,750	1,99,100	2,45,712
(i) Market Loans	70,520	78,023	81,693	1,10,611
(ii) Market Loans in course of repayment	46	52	59	70
(iii) Special Bearer Bonds	951	277	43	15
(iv) Compensation and other bonds	788	1,111	1,200	1,249
(v) Treasury Bills				
(a) 91 Days	6,953	8,840	20,613	32,595
(b) 91 Days funded into Special Securities	66,000	71,000	71,000	71,000
(c) 182 Days	1,078	3,986	-	-
(d) 364 Days	-	-	8,777	8,386
(vi) Special Securities issued to RBI	1,102	1,046	1,046	1,046
(vii) Special Securities issued to International Financial Institutions +	6,566	8,415	14,669	20,365
(viii) Gold Bonds, 1998	-	-	-	375
				<i>contd...</i>
<i>concl.</i>				
<i>Item</i>	<i>1995</i>	<i>1996</i>	<i>1997(RE)</i>	
<i>(1)</i>	<i>(6)</i>	<i>(7)</i>	<i>(8)</i>	
Internal Debt (i to viii)	2,66,467	3,07,869	3,34,914	
(i) Market Loans	1,30,908	1,63,986	1,83,976	
(ii) Market Loans in course of repayment	99	108	108	
(iii) Special Bearer Bonds	3	-	-	
(iv) Compensation and other bonds	1,079	1,757	2,274	
(v) Treasury Bills				
(a) 91 Days	32,327	43,790	43,790	
(b) 91 Days funded into Special Securities	71,000	71,000	71,000	
(c) 182 Days	-	-	-	
(d) 364 Days	8,165	1,875	7,383	
(vi) Special Securities issued to RBI	1,046	1,046	1,046	
(vii) Special Securities issued to International Financial Institutions +	20,635	22,771	19,681	
(viii) Gold Bonds, 1998	1,475	1,534	1,534	

Note: + : These represent non-negotiable non-interest bearing securities issued to International Financial Institutions.

Source: Reserve Bank of India, *Report on Currency and Finance, 1996-97*.

STATEMENT 15.2
Debt Indicators of the Central and State Governments
(As percentage of GDP)

Year	<i>Domestic Liabilities of Centre</i>	<i>External Liabilities of Centre⁺</i>	<i>Total Liabilities of Centre (2+3)</i>	<i>Aggregate Liabilities of States</i>
(1)	(2)	(3)	(4)	(5)
1989-90	52.5	6.2	58.7	20.6
1990-91	52.9	5.9	58.7	20.6
1991-92	51.5	6.0	57.5	20.5
1992-93	50.9	6.0	56.9	20.1
1993-94	49.1	5.4	54.5	18.3
1994-95	47.0	4.9	51.9	17.8
1995-96	45.6	4.2	49.8	17.4
1996-97	44.1	3.8	47.9	17.3

contd...

concl.

Year	<i>Combined Domestic Liabilities of Centre and States</i>	<i>Combined Total Liabilities of Centre and States (3+6)</i>
(1)	(6)	(7)
1989-90	59.1	65.3
1990-91	59.6	65.5
1991-92	58.5	64.5
1992-93	58.2	64.2
1993-94	55.8	61.2
1994-95	53.7	58.6
1995-96	52.4	56.6
1996-97	51.0	54.9

Note: + : at historical exchange rate.

Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy*, various issues.

STATEMENT 15.3

Reserve Bank of India's Initial Support to Borrowings of Central Government +
(₹ crore)

Fiscal Year	Ad hocs	Subscription to 91 Day Auction Treasury Bills	Subscription to Dated Securities in Auctions
(1)	(2)	(3)	(4)
1991-92	5,750	--	4,822
1992-93	11,445	1,147	2,214
1993-94	6,300	839	435
1994-95	1,750	2,405	157
1995-96	5,965	7,789	12,655
1996-97	4,685	3,316	3,698
1997-98 (BE)	#	--	--

contd...

concl.

Fiscal Year	Total Initial RBI Support to Borrowings of Central Government@ (2+3+4)	Net RBI Credit to Central Government (Book Value)
(1)	(5)	(6)
1991-92	10,572	5,508
1992-93	14,806	4,257
1993-94	7,573	260
1994-95	4,311	2,130
1995-96	26,409	19,855
1996-97	11,699	1,934
1997-98 (BE)	16,000*	16,000*

Notes: +: The difference between the initial support to Centre's market borrowing (which included *ad hocs* till 1996-97) and net RBI credit to the Central Government could be explained by net outright sales and repo transactions of the RBI in Government securities, receipts from repayment of dated securities and 91-day auction Treasury Bills from the portfolio of the RBI during the year, rediscounting of 91-day tap Treasury Bills by banks and others with the Reserve Bank, change in Central Government deposits, Government's currency liability, and valuation differences (book value for net RBI credit and face value for initial support data).

@ : Reserve Bank's holdings of rupee coin are excluded.

: In pursuance of the Supplemental agreements between the Government of India and the Reserve Bank the system of *ad hoc* Treasury Bills was abolished with effect from April 1, 1997 and was substituted by a system of WMA from the Reserve Bank.

* : Expected level of Reserve Bank's support to central government borrowing as per the BE for the fiscal year 1997-98.

-- : Nil.

Source: Reserve Bank of India, *Annual Report, 1996-97*.