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Policy Brief

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India Needs to Separate Debt from Monetary Management

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In recent years, the global emphasis on financial sector liberalization combined with large, volatile movements of international capital have led to a debate on issues of central bank independence, fiscal policy, and debt management. The international debt crises in the 1980s and the East Asian Crises of 1997 have led many countries, mainly developed, to assign greater priority to public debt management. Within new regimes of liberalized financial markets and high levels of public debt, governments now seek expertise in debt management techniques to minimize borrowing costs through the development and integration of financial markets, rather than through borrowings at sub-market rates from the central bank.

In many countries, prudent management of risk and the promotion of efficient primary and secondary markets for government securities are important complementary objectives of debt management. Indeed, public debt management can be defined as a process of executing a strategy to raise a substantial amount of gross market borrowings while meeting the cost/risk criteria and also achieving any other specific goal assigned by the government.

To implement the specialized debt management strategy, an increasing number of countries have set up a separate debt office. In choosing to do so, governments seek to emphasize the role assigned to debt management; to preserve the integrity and independence of their central banks (where, traditionally, the debt management function resided); to shield debt management from political interference; and to ensure transparency and accountability in public borrowing. For example, the Accord in 1951 between the U.S. Federal Reserve and the U.S. Treasury emancipated the Fed from assisting the Treasury to borrow at low interest rates and enabled the Fed to focus more sharply on the conduct of monetary policy.

Wherever the central bank is responsible for debt management policy, conflicting objectives may emerge. Even if a separate department with the requisite "firewall" conducts debt management within the central bank, the market will still suspect the influence of inside information on interest rates. Nevertheless, monetary policy and public debt management clearly have to be complementary. The industrial countries generally have separated the objectives and accountabilities of debt and monetary management, but ensure that the activities are coordinated. In the case of Euroland, the sharing of essential information between treasuries, national central banks, and the European Central Bank is important for liquidity management.

June 2005

Public Debt in India – Dimensions

The rising trend in India's public debt should cause concern. Public debt in India has increased from 32 percent of GDP in 1952 to 82 percent in 2004 (Table). Consequently, interest payments on public debt accounted for nearly 7 percent of GDP and 20 percent of total Government expenditure for the financial year ending March 2004. In addition, explicitly guaranteed contingent liabilities extended by the Government amounted to 11 percent of GDP in 2003.

Table
Public Debt and Contingent Liabilities of the Government
(Percent of GDP)

Year (End of March)	Domestic Debt	External Debt	Total Public Debt	Contingent Liabilities
1952	30.8	1.4	32.1	NA
1990	55.5	10.5	66.0	13.9*
2000	59.2	9.4	68.6	11.2
2004	74.9	6.7	81.6	11.2**

* 1992. ** 2003. *Source: Reserve Bank of India.*

In India, external debt can be incurred only by the Central Government, not by the State Governments. Domestic debt, which can be incurred by both Central and State Governments, comprises a heterogenous group of liabilities consisting of internal borrowings (mainly long-term bonds, short-term bills, and loans from banking institutions), use of small savings (mainly post office deposits and medium-term certificates), and recourse to provident funds (mainly social security funds for employees in the organized sector) and reserve funds and deposits (held within the government departments, departmental undertakings, and public enterprises) (Chart). Though the instruments and components of domestic borrowings have been changing over the period, internal debt continues to dominate. The Constitution of India provides for an option for placing a limit on internal debt, but no such limit has been imposed so far.

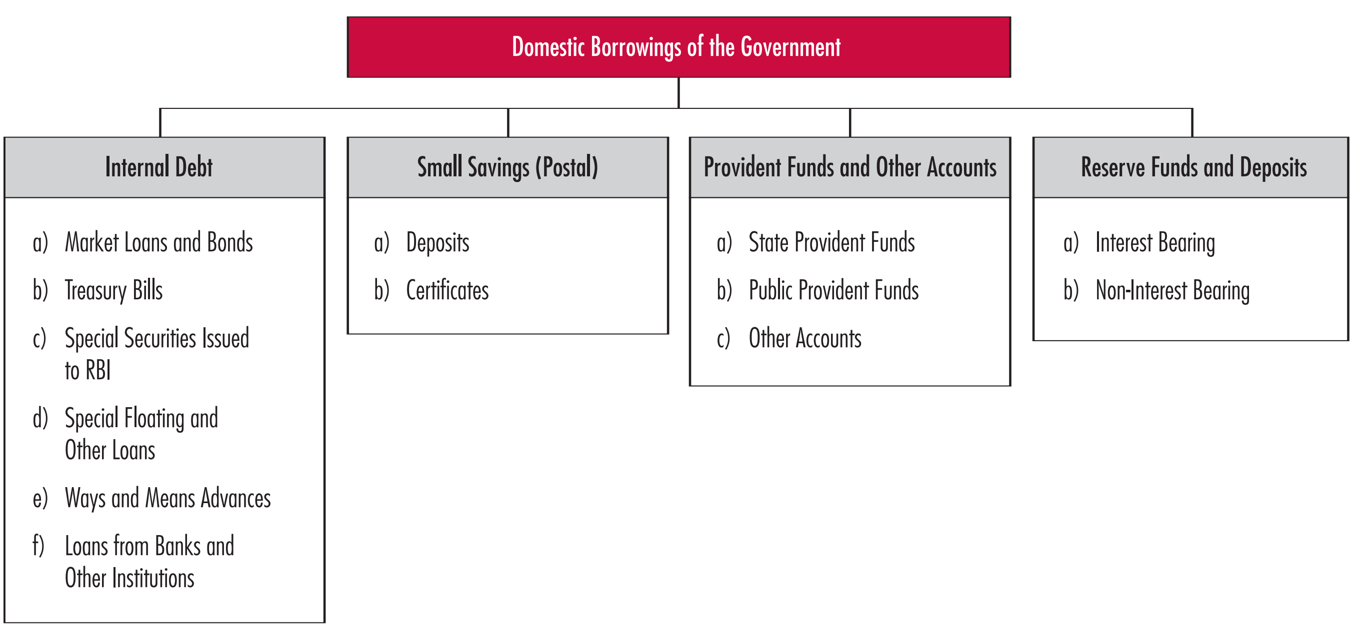
Rising Internal Debt Reflected in Higher Monetary Aggregates

Traditionally, a large component of India's internal debt was incurred at off-market rates of interest (always lower than the market rate), which were statutorily prescribed for subscription by institutional investors. The prevalence of administered interest rates and a mechanism for automatic monetization (unlimited financing of the government deficit by the central bank) of debt resulted in the deficit of the Government-mainly the Central Government-being accommodated by the Reserve Bank of India (RBI). The share of the monetized deficit in the gross fiscal deficit of the Central Government ranged between 30 to 43 percent during 1978-91. The monetized deficit, on average, accounted for more than four-fifths of reserve money during 1970-99, and exceeded 100 percent during 1980-91. The close relationship between the monetized deficit, reserve money, and the price level in India until 2003 is presented in the graph.

How Does India Manage Its Public Debt?

In India, the Central and the State Governments separately manage various components of debt through numerous offices spread across the country. The RBI plays a key role in managing some components of internal debt (mainly market loans and Treasury Bills, accounting for nearly half of domestic borrowings) that

Chart



could conflict with its pursuit of the objectives of monetary policy, which are to provide adequate liquidity to meet credit growth and support investment demand in the economy, and to create a soft and flexible interest rate environment within a stable macroeconomic framework. As well, the RBI is the regulator and supervisor of the financial system, including banks, and also of some financial markets (money, government securities, and foreign exchange). In contrast to the recent trend in many developed economies of assigning the single or primary objective of price stability to the central bank, the RBI has to balance the needs of the markets (manage liquidity), government finances (fiscal requirements), the balance sheets of the banks (asset prices and interest rate movements), and the general price level (growth of money supply). The specific objectives of debt management accordingly are subsumed in the overall objectives of monetary policy.

In India, the issue of separation of debt from monetary management was debated in the mid-1990s, when the conclusion was that such a separation would require well-developed financial markets and a credible commitment of the Government to contain budget deficits. At that time, interest rates in India generally were still administered. In the past decade, due to financial sector reforms undertaken since 1991, financial and capital markets have developed and the last remnants of interest rate controls, those on small savings, are now almost dismantled. The development of the markets has led to convergence of interest rates throughout the economy and to higher turnover in the secondary market. The borrowing requirements of the Government are successfully being met from the market, with no or minimal devolvement on the RBI or the primary dealers, in recent years. Also, the Fiscal Responsibility and Budget Management Act of 2003 places annual restrictions on the fiscal deficit of the Government.

Recommendation

In view of the above-mentioned developments, the time has come to revisit the arrangements for managing public debt in India. Debt and monetary management should be separated in India. The separation of debt management from monetary policy will help the central bank to focus exclusively on price stability, which will provide transparency in its operations and thereby enhance its credibility. The assignment of the function of debt management to a separate office would help to establish specific accountability and responsibility on the debt manager. This could lead to an integrated and more professional management of all government liabilities, currently dispersed among different offices, with a mandate to operate on sound economic and commercial principles. The development of a focused and transparent debt management strategy also could ensure that funds are available to the Government at competitive rates of interest that will lead to expenditure prioritization and to fiscal discipline in budget making.

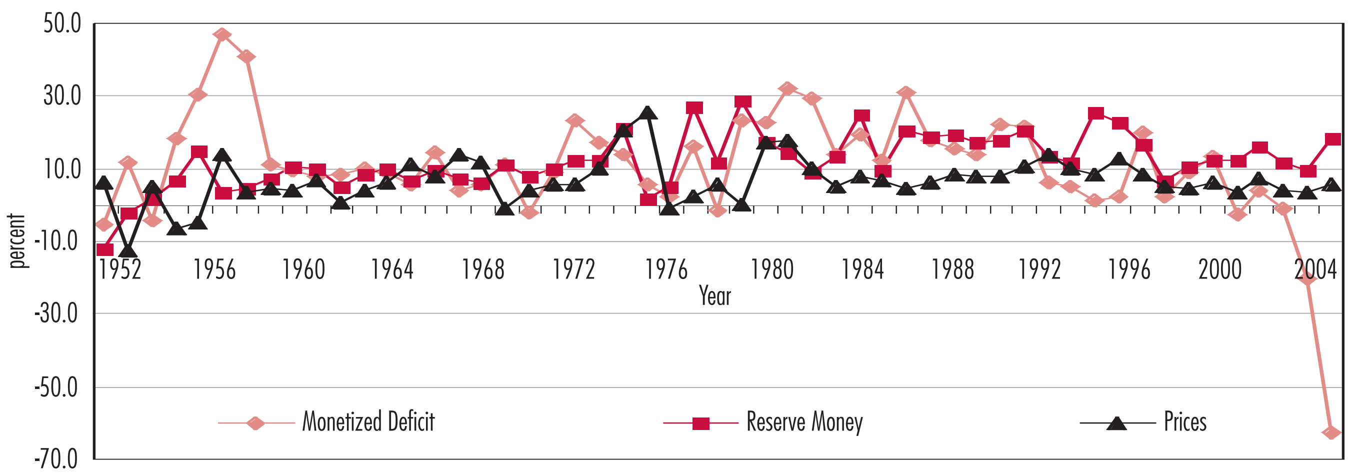
Conclusion

The Reserve Bank of India, in its Annual Policy Statement on April 28, 2005, for the year 2005-06, announced its intention to reorient government debt management operations entailing functional separation between debt management and monetary operations within RBI. This first step initiating the separation of the two operations is expected eventually to culminate in the RBI focusing on monetary policy with a separate office under the Ministry of Finance managing government debt.

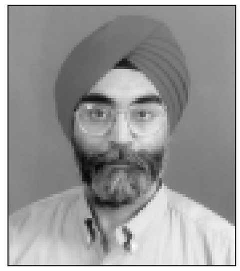
Reference:

Singh, C. (February 2005). *Public Debt in India: The Need to Separate Debt from Monetary Management,* SCID Working Paper 240 at http://scid/pdf/SCID240.pdf

Annual Growth Rate of Monetized Deficit, Reserve Money and Prices (1952–2004)



About the Author



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The views expressed in this Policy Brief are Singh's alone and do not represent those of the RBI.

SIEPR Policy Briefs
are underwritten by a generous grant from the Taube Family Foundation.

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A publication of the
Stanford Institute for Economic Policy Research
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579 Serra Mall at Galvez Street
Stanford, CA 94305
MC 6015