Y V Reddy: The Reserve Bank and the State Governments – partners in progress

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Madras School of Economics, Chennai, 23 September 2007.

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Respected Dr. Rangarajan, Dr. Raja Chelliah, Dr. Srivastava, Professor Kumar and friends,

I am thankful to Dr. Srivastava for affording me the opportunity to participate in the annual day celebrations of the Madras School of Economics. It is an honour and privilege to be associated with the activities in a distinguished gathering such as this one.

I was born in a village in Kadapa (then Cuddapah) district but went to High School in Chennai (then Madras), studying in Telugu medium. After a two-year stint in Government Arts College, Anantapur, I was back in Chennai for pursuing my university level studies in economics. My participation today in the annual day celebrations of the Madras School of Economics gives me an opportunity to express my gratitude to (Madras) Chennai which helped me in becoming and being a student of economics.

There are several reasons for selecting this subject for my address today. First, in the Indian federal polity, the States, relative to the Centre, have taken the centre-stage in the reform process since the areas of highest national priority now fall essentially within the purview of the States. For instance, agriculture, education, public health, sanitation and much of physical infrastructure belong primarily to the domain of the State Governments. Second, Dr. Rangarajan and Dr. Srivastava were Chairman and member, respectively, of the Twelfth Finance Commission, which made historic contribution to the Centre-State relations. It is also noteworthy that they addressed the Sixteenth Conference of State Finance Secretaries, held at the RBI. Third, it was Dr. Rangarajan who, in 1997, initiated the process of active interface between the Reserve Bank and the State Governments a decade ago, when he inaugurated, as the Governor of the RBI, the first Conference of State Finance Secretaries. Finally, there is very little literature available on the theory or practice of the role of the central banks at the level of sub-national governments. Hence, there may be some merit in recording our experience in this regard. I am taking this opportunity to chronicle the unique and productive partnership between the RBI and the State Governments in securing the progress of our economy, as part of economic reforms.

On November 8, 1997, Dr. Rangarajan, the then Governor of the RBI, in his inaugural address at the First Conference of the State Finance Secretaries convened by RBI, had flagged the issues that needed to be focussed upon in management of State finances. These included: alternative methods for borrowing by the States, statutory ceiling on debt, setting up of consolidated sinking fund and the issuance of State Government guarantees. I would like to report that most of his expectations have since been substantively met, as I will enumerate today, a little later.

I would also like to place on record the high priority that continued to be accorded to this collaborative process by Dr. Jalan who succeeded Dr. Rangarajan as the Governor, RBI. For instance, in his inaugural address at the Tenth Conference of State Finance Secretaries, on June 7, 2002, stressing on the cooperative framework between the Centre and the States, Dr. Jalan had pointed out that there were lessons to be learnt from the coordinated approach adopted by some of the large federal governments in managing their finances successfully in contrast to some of the Latin American nations. He had noted that although the Centre's large deficit had constrained its ability to support the States, the harmonious relations amongst the States, the Centre and the RBI, which are involved in the management of public finances in India, had enhanced the stability and integrity of India's financial system. He had also reiterated the problems associated with the "automatic debit mechanism", stating that a

State could not manage its finances if such a mechanism pre-empted a large portion of its available funds.

Mutual trust

The "Reserve Bank of India" and "banking" find a listing in the Seventh Schedule of the Indian Constitution and hence, fall within the exclusive jurisdiction of the Central Government. The Reserve Bank of India Act, 1934 provides that the Central Government *shall* entrust the RBI with all its money, remittance, exchange and banking transactions in India and the management of its public debt, and shall also deposit all its cash balances with the RBI, free of interest. On the other hand, the RBI *may*, by agreement with any State Government, take over similar functions on behalf of that Government. Accordingly, the RBI is the banker to both the Central Government and all the State Governments, except two, in the Indian Federation.

The RBI also manages the open market borrowings of the Central Government and all the States, with two exceptions. The market-borrowing programme of the State Governments is finalised by the Government of India and the Planning Commission, keeping in view the provisions of Article 293(3) of the Constitution of India. The Article stipulates that a State may not, without the consent of the Government of India, raise any borrowings if it has any loan outstanding, which is repayable to the Government of India.

The RBI has, over the years, closely interacted with the State Governments in its developmental role – particularly in areas of development of agriculture, and small industries. The RBI was specifically entrusted with an important promotional role, since its inception, of financing agricultural operations and marketing of crops. In fact, the Agricultural Credit Department was created simultaneously with the establishment of the RBI in 1935.

The Reserve Bank prepares and publishes an annual Study on the State Government Finances. This is a unique study since it compiles, consolidates and analyses detailed data on the budgets of all the State Governments. It also documents the policy initiatives on State finances and debt management by the State Governments, the Government of India and the Reserve Bank. The study has been well received by policy makers and academicians, both in India and abroad, and is an important reference document.

It is noteworthy that the interface between the RBI and the State Governments arises not only out of statutorily mandated obligations but also voluntarily, based on mutual trust. The mechanism of bi-annual conference of the State Finance Secretaries has formalised and strengthened the process of partnering for progress, based on mutual respect, through a process of continuing consultations, but with the States retaining their freedom. Apart from the State Finance Secretaries, senior functionaries of the Government of India, the Comptroller and Auditor General of India, the Controller General of Accounts and the Planning Commission as also heads of select departments of the Reserve Bank are invited to the Conference. There are occasions when fiscal experts such as Mr. A. Premchand, Mr. M.S. Ahluwalia from the Planning Commission, leading commercial bankers and representatives of credit rating agencies are also invited to participate and contribute to the specific issues on the agenda.

Open market borrowings

The normal procedure followed for open market borrowings, until the first half of the nineties, was that the RBI would complete the combined borrowings of all States in one or two tranches at a predetermined coupon, which was common to all States and was on par with that of the Central Government. After announcement of the loan, the RBI would write to the banks indicating the contribution expected from them, mainly based on their market-share of deposits, with a request to invest in the State Government bonds. Thus, high statutory preemptions in the form of Statutory Liquidity Ratio (SLR) in respect of the banks and the tying-up of the loans by the RBI ensured a captive market for these loans amongst the banks and the successful completion of the allocated borrowing programme.

With the substantial increase in the market borrowing programme of the Central Government, progressive reduction in the SLR, increasing sophistication of the Indian debt markets offering diversified portfolio choices to banks, mark-to-market valuation norms, changes in risk weighted capital prescriptions and the deteriorating financial position of the States, it was becoming increasingly difficult to complete the market borrowings of the States, through the tranche system, at pre-announced coupon.

To reflect these new realities, including the market perception of the status of the State Governments, in 1997, the coupon rate for the entire borrowing programme for all the States was fixed broadly on the basis of a mark-up (which was initially 25 basis points and later increased to 50 basis points) over the yield of ten-year stock of the Central Government. Apart from the fact that the banks displayed an increasing reluctance to voluntarily invest in the State Government paper, the market had started discriminating amongst the States based on their perceived strengths and weaknesses; thus adversely affecting completion of the approved borrowing programme for the States.

The Central Government had switched over to the auction method for its open market borrowing programme since 1993 and in view of the experience described above, it was felt necessary for the State Governments to explore the possibility of adopting a flexible approach with regard to interest rate, maturity, etc., of their borrowings. It was also felt that in view of inter-State disparities, a gradual and cautious approach was necessary. Based on the consensus at the first Conference of the State Finance Secretaries, an option was made available to the State Governments to enter the market through a flexible approach, on their own, to the extent of 5 to 35 per cent of their gross market borrowings. The timing and volume of issues for auction were to be decided by the RBI, in consultation with the State Governments, taking into account the market and liquidity conditions. This dispensation enabled the well-managed States to take advantage of the market conditions and raise loans at finer rates while the smaller States were able to protect their interests by substituting a part of their borrowings under the totally pre-announced coupon approach, with the auction method. The State Governments were subsequently encouraged to progressively further increase the share of market-borrowings under the auction route initially to 50 percent and thereafter to cover the entire market-borrowings.

The auction system was experimental since the year 1998-99 with one State adopting the auction route in January 1999. The number of States adopting the auction route increased gradually in subsequent years.

With the implementation of the recommendations of the Twelfth Finance Commission (TFC), the year 2005-06 marked a watershed in the evolution of the finances and the (open market) debt management operations of the State Governments. Spurred by the moderation in fiscal imbalances and progressive enactment of Fiscal Responsibility Legislation by the States – induced in some measure by the incentivised Debt Relief Scheme recommended by the TFC – the market perception regarding the fiscal position of the States seemed to have improved considerably. As many as 24 States opted for the auction route during 2005-06 as compared with only three States in the previous year. The States raised 48.5 per cent of their total borrowings through the auction route during 2005-06. The cut-off yields in the auctions were, in general, lower than the tap issues.

The market borrowings of the State Governments during 2006-07 and 2007-08 so far have been raised entirely through the auction route, with a general decline in spreads. In brief, the migration from the system of administered borrowing programme to the auction method of borrowing in respect of the States was achieved gradually and through a consultative process between the States and the RBI.

Consolidated Sinking Fund

At the request of the State Governments, the Reserve Bank had prepared a model Consolidated Sinking Fund (CSF) Scheme and circulated it amongst them for adoption / consideration in 1999. By the time of the ninth Conference of the State Finance Secretaries held in November 2001, 11 States had set up the CSF, which is being administered by RBI.

The Twelfth Finance Commission had recommended that the CSF may cover repayments in respect of all the loans of the State Governments (and not just open market borrowings). Furthermore, the Bezbaruah Committee on Ways and Means Advances (WMA) to States had recommended that the States would be entitled to the Special WMA to the extent of their net incremental annual investment in the CSF, subject to the prescribed ceilings. Against this backdrop, the Reserve Bank circulated a revised model scheme of CSF amongst the State Governments in May 2006. As on June 30, 2007, of the eighteen State Governments that had set up the CSF, 11 had established it as per the revised CSF scheme. Many more States have intimated their intention to adopt the revised CSF scheme, as administered by RBI.

Prepayment of debt

In the context of build up of cash balances, two States proposed to utilise their surplus cash to pre-pay a part of their outstanding open market debt. In this connection, the modalities of buyback auctions were finalised by the Reserve Bank in consultation with these State Governments and the Government of India. General issues relating to the pre-payment of debt were discussed at the 18th conference of the State Finance Secretaries, held in August 2006. The RBI has conducted two rounds of buyback auctions in February and March 2007.

State Government guarantees

Issues relating to State Government guarantees have also been discussed in almost every conference of the State Finance Secretaries. Against the imperative of infrastructural development, the States have been under pressure to provide guarantees for facilitating the flow of funds to the high-priority sectors, State public sector enterprises, developmental institutions and local bodies, for commercial as well as non-commercial activities as also for urban development. The element of risk associated with such guarantees, transparency with regard to the guarantee policies and the magnitude of guarantees extended by the State Governments have raised concerns regarding the optimal or sustainable level of such guarantees. It is well recognised that while the guarantees, being contingent liabilities, do not form part of the debt, as conventionally measured, these have, in the eventuality of default, the potential of straining an apparently sound fiscal system.

At the first Conference of the State Finance Secretaries held in November 1997, the issue of government guarantees was deliberated upon at length and the view taken was that, in the interest of prudent financial management and the credibility of the guarantees issued, there was a need for a policy on guarantees for each State Government within certain national parameters. Accordingly, a Technical Committee was constituted to examine the issue of State Government guarantees, in all its aspects. The report of the Committee was discussed at the third Conference of the State Finance Secretaries, held in January 1999, and pursuant to the recommendations of the Committee, several States have since taken the initiative to fix a ceiling on guarantees to be issued by them.

The devolvement probabilities of various guarantees are not identical and consequently, all guarantees can not be treated uniformly in terms of their fiscal impact. In order, therefore, to assess the fiscal risk arising out of guarantees in a more realistic and objective manner, there was a need to evolve a methodology for classifying guarantees into appropriate categories, with each category reflecting broadly similar fiscal impact. This, in turn, was expected to facilitate the fixing of ceiling on guarantees in a non-mechanistic fashion to better capture the risk inherent in guarantees, and to enable adoption of better provisioning techniques to cover these contingent liabilities. In this backdrop, it was decided to constitute a Group of State Finance Secretaries on the Fiscal Risk on State Government Guarantees to examine the fiscal risk of guarantees extended by the State Governments. The report of the Group was discussed at the tenth Conference of the State Finance Secretaries, held in June 2002.

The general consensus that emerged at the Conference was to place the Report of the Group in the public domain. It was also agreed to explore the possibility of extending the scope of the relative RBI circular addressed to the banks, to the financial institutions also so that they too would undertake due diligence and proper appraisal in financing of projects rather than merely relying on the State Government guarantees in their favour. It was also proposed that States could be provided technical assistance in regard to assigning appropriate risk weights to the guarantees.

The Reserve Bank organises workshops on the evaluation of fiscal risk of guarantees for the benefit of State Government officials. Representatives of credit rating agencies are also invited to give presentations at the workshops. So far, four such workshops have been organised. It was also decided that the State Governments would be encouraged to seek, for their internal use, credit ratings from a rating agency so that they could initiate appropriate measures to improve their financial performance when they approached the market to mobilise resources.

The Reserve Bank circulated a draft scheme on Guarantee Redemption Fund (GRF) amongst the State Governments for voluntary adoption. As an incentive to build up the Consolidated Sinking Fund (CSF) and GRF, the Bezbaruah Committee (2005) had recommended that net incremental (i.e., new investment less redemption/liquidation) annual investment of States in CSF/GRF would be made eligible for availing Special WMA, but up to a ceiling equivalent to the Normal WMA limit. Keeping this in view, the Reserve Bank circulated revised draft GRF scheme amongst the State Governments in May 2006. As on June 30, 2007, eight State Governments had set up the GRF, of which three had put in place the revised scheme.

Ways and Means Advances, and cash management

The Reserve Bank of India (RBI) has been extending Ways and Means Advances (WMA) to State Governments since 1937 with the objective of covering temporary mismatches in the cash flows of their receipts and payments.

The WMA Scheme has been periodically revised, right since the early 1950s, in the light of the perceived requirements of the State Governments, keeping in view the evolving fiscal, financial and institutional developments as well as the objectives of monetary and fiscal management. State-wise limits in respect of Normal and Special WMA are determined based on certain parameters and have been revised, periodically, over the years. An overdraft (OD) occurs whenever these limits are exceeded. Maximum time-period (days) and/or financial limits up to which the State Governments can remain in overdraft have been specified; these limits have also been revised periodically. Payments on behalf of the State Governments are suspended in case the OD limits are breached.

Till the late 1990s, the Normal and Special WMA limits of State Governments were fixed in terms of specified multiples of their minimum balances kept with the RBI. Both the minimum balances and the “multiples” to obtain the Normal WMA limits, were revised upwards a number of times (though not necessarily at the same time) over the years.

There have been strong demands from several States, from time to time, for upward revision of the WMA limits. RBI had taken the view that WMA is meant for meeting the temporary mismatches in the cash flows and hence, any upward revision in the WMA limits to meet structural deficits of the States is inappropriate. The matter remained a contentious issue for some time.

The initiation of the Conference of State Finance Secretaries in 1997 induced a transformation in the approach to formulating changes in the WMA Scheme. Distinct from the past, Advisory Committees were periodically constituted by the Reserve Bank to review the prevailing WMA arrangements and recommend changes, as considered appropriate, in the light of the evolving circumstances. The involvement of experts from outside the Reserve Bank in such Advisory Committees helped to strengthen and broad-base the modalities for effecting appropriate changes in the WMA Scheme. In fact, three Advisory Committees, that have been constituted so far, have been chaired by experts from outside the Reserve Bank and have included other "external" experts apart from senior functionaries from the Reserve Bank, as members.

The first informal Advisory Committee on the WMA to State Governments was constituted in 1998, under the chairmanship of Shri B.P.R. Vithal. As a major break from the past practices, the Vithal Committee recommended the de-linking of the size of the Normal WMA limit with the minimum balances held by the States on the grounds that *"fixing the WMA limits as multiples of an unchanged minimum balance, as in the past, does not capture the differing needs of the States in line with the different growth in their budgetary transactions. This has resulted in wide inter-State variations in the WMA limits in relation to the size of the Budget, and this needs to be corrected."* The Vithal Committee instead proposed linking the normal WMA limit to the cash flows of the State. The recommendations were implemented in the light of further consultations with the States and the Centre.

Subsequently, similar committees (Ramachandran Committee, 2003 and Bezbaruah Committee, 2005) have refined and improved upon the WMA arrangements. It is noteworthy that WMA arrangements have ceased to be a contentious matter amongst the Centre, States and RBI on account of the reliance placed on the advice from the outside experts and intensive consultations amongst the stakeholders, in finalising the arrangements.

The upsurge in the surplus cash balances of some of the State Governments since the middle of 2004-05, in contrast to the liquidity pressures witnessed in the earlier period, has posed newer challenges to financial and cash management of State Governments. The issues relating to investment of cash balances of the States were discussed at the 18th Conference of State Finance Secretaries held in August 2006 and also in the 20th Conference of State Finance Secretaries held in August 2007. Taking note of the discussions, the Reserve Bank is in the process of formulating the plans in this regard, in consultation with the Centre and the States.

Advice on fiscal management

The importance of fiscal transparency has got reinforced in the recent years after Government of India subscribed, in 1997, to the Special Data Dissemination Standards (SDDS) promulgated by the International Monetary Fund. In the light of this development, it was decided to constitute a Group of the State Finance Secretaries to suggest various measures of disclosure, which could be introduced in the budgetary exercise of the State Governments. It was also decided that the Group could lay down a model budget for the States, which would enable the Legislature and the public to enhance their understanding of the State finances. The Group suggested, inter alia, that it would also be useful if the State Governments could publish a document akin to the Budget at a Glance of the Union Budget furnishing the estimated levels of Gross Fiscal Defiit (GFD) and Primary Deficit (PD) of the State, including their ratio to the State Development Product (SDP). The document could also incorporate time-series data on important fiscal variables of the State. The levels of outstanding debt, guarantees extended, wages and salaries, and subsidies could also be explicitly indicated. Many States have, in the light of these deliberations, modified their budget-related documents to enhance fiscal transparency.

A Group was constituted in February 2003 to undertake a study of the pension liabilities of the State Governments and make suitable recommendations. The Group observed that if pension payments of the States were to grow at the historical average growth rate, pension payments alone would pre-empt about 20 per cent of the total revenue receipts of the States and as much as 30 per cent of the revenue receipts in the year 2010-11. Thus, purely from the perspective of fiscal sustainability of the States and the magnitude of the problem, structural alteration in the existing pension scheme, appeared necessary. The Group recommended introduction of contributory pension scheme/s for the new employees of the State Governments in lieu of the existing non-contributory defined-benefit pension scheme. The Group also recommended three alternative pension models, which are to be acted upon by the States as they consider appropriate. As per the available information, 19 State Governments have notified a defined-contribution pension scheme for their new employees.

Recognising the absence of unanimity about the exact level, composition, and methodology for compiling the liabilities of the State Governments in India, it was decided in August 2004, to constitute a working group to evolve a methodology. The Group recommended that the compilation of data on the budgetary liabilities should be consistent with those in respect of the Gross Fiscal Deficit and accordingly, specified the constituent items. The Group also recommended exclusion of the implicit/contingent liabilities from the definition of budgetary liabilities, reckoning the wide divergence in views on the various items that should be included under implicit liabilities. It, however, recommended the disclosure of information on various implicit liabilities along with the budgetary liabilities. The Group recommended specific formats for timely release of data on the liabilities in the budget documents of the State Governments. The Group also recommended that the Reserve Bank should compile and publish the data on the liabilities of the States in its annual study on the State budgets; this recommendation has already been implemented.

Fiscal responsibility legislation

The RBI had provided detailed and comprehensive technical inputs to the Government of India for formulating a Fiscal Responsibility and Budget Management Law, which culminated in the enactment of the Fiscal Responsibility and Budget Management (FRBM) Act by the Parliament. In view of this successful outcome, State Finance Secretaries expressed a desire for similar advice to them from the RBI. Accordingly, a group was constituted in October 2003 with select State Finance Secretaries and a representative from the Government of India, Ministry of Finance, as members, to prepare a model fiscal responsibility legislation for the States. The draft Report of the Group was discussed at the 14th Conference of the State Finance Secretaries, held in August, 2004 and the final report was submitted to the Reserve Bank in January 2005. The Group decided that the model legislation would generally follow the pattern of the Central FRBM Act, and build upon the State fiscal responsibility legislations already enacted. The Group also took into account the international best practices available in the area as well as the recommendations of the various committees on fiscal transparency and on the issues related to voluntary disclosure of information by the State Governments. Various dimensions of the fiscal legislative framework, such as, the choice of targets, the road map for achievement of the targets, need for a detailed set of illustrative rules, independent evaluation criteria, prioritisation of capital expenditure, treatment of contingent liabilities including guarantees, computation of pension liabilities, etc., were deliberated upon to arrive at a consensus. The Group felt that the model Bill would provide guidance to the States for enacting their fiscal responsibility legislations with reference to certain benchmarks.

The objective of the Group was to design a template for the fiscal responsibility legislation for the States on the basis of feasibility on pragmatic considerations and enforceability, taking into account the diverse requirements of various States. It was considered desirable to allow each State to take a view on the sequencing of adoption of various provisions of the model Bill, fixing the actual targets, time frame for implementation thereof and allocating the provisions between the Act and the Rules, depending on its fiscal capabilities and further refining the provisions given in the model bill within the overall framework of fiscal prudence and sustainability.

All State Governments, except two, have already enacted fiscal responsibility legislation.

New arrangements for borrowings by the States

According to the TFC, it would be appropriate for the States to take advantage of the prevailing market rates and avoid the spread charged by the Centre on the assistance provided by it. The pattern of Central assistance included loan as a major element in respect of general category States, which was implicitly funded from borrowings by the Centre and hence, the terms of loans extended to the States reflected the Centre's cost of borrowings. To the extent these arrangements prevailed, there was, in effect, intermediation by the Centre in the provision of loans to the States as part of the Central assistance. The TFC, therefore, recommended that the Central Government should not act as an intermediary for future lending and allow the States to approach the market directly. If some fiscally weak States were unable to raise funds from the market, the Centre could borrow for the purpose of on-lending to such States, but the interest rates should remain aligned to the marginal cost of borrowing for the Centre. This approach was accepted by the Central Government, in principle, to be implemented in phases, in consultation with the Reserve Bank.

The new arrangements for ensuring disintermediation of the Centre in respect of States' borrowings were deliberated upon, at the Conferences of State Finance Secretaries and by the Monitoring Group on Cash and Debt Management of the Government of India and RBI. In the light of these discussions and in order to operationalise the new arrangements, the Government of India constituted a Technical Group, with Smt. Shyamala Gopinath, Deputy Governor, RBI as chairperson and the officials of the Government of India, select States and the Reserve Bank, as its members. The Technical Group submitted its report to the Government of India in December 2005 and made several recommendations.

In tune with the recommendations of the Group, there has been noticeable progress in regard to drawing up of calendar of borrowings, re-issuance of securities and adoption of the auction method for borrowing by the States. In addition, on the lines of the recommendations of the Working Group on Liquidity of State Government Securities (Chairman – Shri. V.K.Sharma), 2005, State Development Loans (SDLs) have been made eligible for repo transactions under the liquidity adjustment facility of the RBI and it has been decided to introduce the non-competitive bidding facility in respect of the primary auctions of SDLs. As far as the arrangements for sharing the corpus of the National Small Savings Fund (NSSF) are concerned, in accordance with the decision of the National Development Council, the obligatory share of the States has been reduced to 80 per cent with effect from the year 2007-08.

Loan Council

The TFC had also recommended that *"…..States, like the Centre, must decide their annual borrowing programme within the framework of their respective fiscal responsibility legislations…. The overall limit to their annual borrowings from all sources should be supervised by an independent body like a Loan Council with representatives from the Ministry of Finance, Planning Commission, Reserve Bank of India and the State Governments. The Council may, at the beginning of each year, announce the annual borrowing limits for each State, taking into account the sustainability considerations….."* (Para 15.7).

It was, however, felt that setting up of a new institution, like the Loan Council, would entail additional cost in terms of physical and human resources and would take time. Moreover, a large majority of States are currently seized with the task of addressing structural issues in managing government finances which, if carried on to their logical conclusion, could usher in an era of debt sustainability over the medium-term of the TFC period. The Loan Council could lose its *raison d'etre* once the fiscal situation became tractable, as seems to have been the case with the Australian Loan Council, which provides the international best practice in respect of coordinated borrowings by the Federal and State Governments. Against this backdrop, the Technical Group felt that the objective of securing coordinated borrowings between the Centre and the States on the one hand, and between the States on the other, could be best served by the setting up a Standing Technical Committee (STC) with representation from the Central Government, State Governments and the RBI.

The Terms of Reference of the STC are to make annual projections of borrowing requirements of the State Governments; build alternative scenarios and suggest alternative strategies and instruments for raising resources of the States; advise on a mechanism for annual allocation of market borrowings amongst the States; take note of actual borrowings of the State governments during the year vis-à-vis the budgeted GFD and develop an appropriate database that would facilitate the monitoring exercise; assess fiscal risks from issuances of State Government guarantees; and advise State Governments on various issues relating to their borrowings.

The first meeting of the STC was held during the 20th Conference of the State Finance Secretaries held in August 2007.

Management of foreign exchange risk

The external assistance by multilateral agencies to the States has traditionally been routed through the Central Government as part of the Central assistance, with the Centre bearing the foreign exchange risk. However, as part of the policy of disintermediation of the Centre in the borrowings by the States, it was decided by the Central Government that there should be a back-to-back transfer of external assistance to the States. At the 16th Conference of the State Finance Secretaries, some of the State Finance Secretaries suggested that the RBI could play an advisory role in assisting the States in hedging their exchange rate risks arising from the policy of back-to-back transfer of external assistance.

In the context of the TFC recommendations and following the discussions at the 19th Conference of the State Finance Secretaries, held in January 2007, the first workshop on the management of foreign exchange risk by the States through the financial markets was organised by the Reserve Bank in May 2007, for the benefit of the State Government officials.

The States have also proposed alternative mechanisms for providing for foreign exchange risk by setting aside funds in their budgets, where the Reserve Bank is expected to play a role in managing these funds on the lines of the CSF. These proposals were discussed at the 20th Conference of the State Finance Secretaries, held in August 2007.

Selective broadening and deepening of relationship

There are many areas in which there has been close coordination between the RBI and the States. For some of the important areas of the RBI's responsibilities, there are standing institutional mechanisms at the State level, with which the Regional Offices of the RBI and the concerned officials of the State Governments are associated. The more important areas of close coordination relate to the provision of overall physical security for the banking system, matters relating to coins and currency and responses to natural calamities.

Considerable decentralisation of powers and responsibilities to Regional Offices of the RBI has been brought about to facilitate locally relevant solutions to the problems, as they arise. The empowerment of Regional Offices has been combined with promoting State-specific initiatives, both in policy and implementation. The Regional Offices play a facilitating role in bringing together the contending parties when some tensions arise, that affect the financial system. One of the examples relates to resolution of stand-off between a State Government and the microfinance institutions on the terms of loans granted and methods for recovery of dues employed by the microfinance institutions. Similarly, considerable latitude is provided, to suit the local conditions, in the deliberations of State Level Bankers' Committees, and there are many instances of the State Finance Ministers and Chief Ministers presiding over such meetings.

In the broad area of banking, an innovative mechanism has been designed to resolve the issue of dual control in regard to the urban cooperative banks. Several States, together accounting for over seventy percent of urban banking activity, have signed Memorandum of Understanding with the RBI to constitute in each State a Task Force on Urban Co-operative Banks (TAFCUB) to ensure co-ordinated actions to revive and strengthen this sector. This has been, by all accounts, an outstanding success. Similarly, Empowered Committees have been constituted in all the States to reorganise, strengthen and expand the Regional Rural Banks. In the matters relating to revival of rural cooperatives also, State-specific packages are considered. Special plans for coordinated actions for select States, where the spread and depth of banking services are poor, have been mounted, the examples being the north-eastern States, Uttarakhand and Bihar.

More recently, a vigorous programme of financial inclusion has been initiated to ensure the offer of banking services to the whole population. The RBI plays the lead role in each State, while the State Government participates in the movement, for operationalising the approach. The States have particular interest in this programme to ensure efficient and inexpensive disbursal of funds under several social security related and rural employment programmes. The recent developments in technology are facilitating this process. Simultaneously, some States have shown enthusiasm for extending financial literacy and RBI is encouraging its Regional Offices to respond, preferably in the local language, and the RBI website attempts to disseminate information in several of these languages.

We do recognise that while we should avoid overstretching our resources, we should be willing to interact and respond positively to the genuine demands of the State Governments that are legitimate concerns of the RBI. No doubt, the State-specific considerations would govern State-specific responses, within the overall policy framework of the RBI. There are many areas, which are perhaps of greater relevance to the Central Government than to the RBI, in which the States seek the RBI's involvement but we are constrained to carefully distance ourselves. Some time ago, there was a strong appeal from several States that the RBI should award a rating to the quality of fiscal management of all the States, which would carry greater weight and foster better response from the political leadership of the States concerned. The RBI had to politely decline the request since, as an institution, it should not appear to be ranking the States or passing judgments on their fiscal performance.

Outcomes and challenges

Having delineated the efforts and the processes of collaboration between the States and the RBI, it is only appropriate to briefly enumerate the outcomes and to recognise the critical challenges that lie ahead for the State finances and the RBI.

First, the progressive enactment of Fiscal Responsibility Legislations (FRLs) by as many as 26 State governments has indeed strengthened the fiscal consolidation initiatives at the State level.

Second, the gross fiscal deficit of States, which had increased from an average of 2.8 per cent of GDP in the first half of the 1990s to an average of over 4 per cent of GDP in the first half of the present decade, was placed at 2.5 per cent of GDP in 2005-06 and is expected to be brought down to 2.4 per cent in the budget estimates for 2007-08. The revenue deficit, which had increased to an average of 2.2 per cent of GDP in the first half of the present decade, has remained at less than 0.1 per cent since 2005-06. In fact, an aggregate revenue surplus (of 0.4 per cent of GDP) has been budgeted for 2007-08. All States, except eight, have budgeted for a revenue surplus during 2007-08.

Third, open market borrowings of the State Governments have been conducted entirely through the auction route during 2006-07 and 2007-08 (so far). The spreads for almost all the States, over the yields of Central Government securities of comparable maturity during 2006-07 and 2007-08 so far, has remained well below 50 basis points (spread fixed in the case of tap issuances), reflecting favourable market perception.

Fourth, as far as the State Government guarantees are concerned, the volume is on a declining path: guarantees were placed at 6.5 per cent of GDP as of end-March 2005 as compared with 8.0 per cent as at end-March 2001. Many States have imposed administrative/ legislative ceilings on guarantees. Eight States have set up Guarantee Redemption Funds to provide for the possible invocation of guarantees.

Fifth, 18 States have set up Consolidated Sinking Funds to provide for orderly repayments of their open market borrowings. Of these, 11 States have adopted the revised CSF scheme which provides for repayments of all liabilities (and not just open market loans). Many more States have proposed to set up the revised CSF.

Sixth, the cash management of the State Governments has shown a marked improvement in recent years. The daily average utilisation of Normal WMA, Special WMA and overdrafts by the State Governments declined during 2006-07. During 2006-07, eight States availed WMA as against 12 States in the previous year. Only two States resorted to overdrafts during 2006-07 as against eight States in the previous year.

Notwithstanding the positive developments and prospects, there would remain a few areas of concern.

There are certain risks to the process of fiscal consolidation such as the expected increase in expenditure from the revision of pay scales of the State Government employees, pursuant to the implementation of the ensuing recommendations of the Sixth Pay Commission. In this connection, State Governments would need to make their budgets robust enough to enable them to steadfastly adhere to the provisions of their Fiscal Responsibility Legislations. Fiscal empowerment through revenue augmentation holds the key to address such fiscal risks.

Initiatives by the States would be needed to develop a calendar for open market borrowings by the States, on the lines issued by the Government of India. This would enhance transparency, reduce uncertainty for the market participants and thereby help to further smoothen market-borrowing operations. Re-issuance of State Government securities would also help to build up a critical minimum size of securities, which would, in turn, help to enhance their liquidity.

The Reserve Bank continues to receive complaints from the banks and financial institutions regarding defaults in honouring of obligations under the State Government guaranteed bonds. Such issues need to be addressed by the State Governments as this would impact on their credibility and market perception of their financial position.

At the same time, issues relating to the insistence of certain (re-financing) institutions for provision of State Government guarantees, irrespective of the financial viability of projects, perhaps on account of legal requirements, also need to be addressed at an appropriate forum.

The State Government expenditures on education and health remain low at around 2.5 per cent and 0.7 per cent of GDP, respectively. These expenditures may need to be enhanced to make a long-term impact on the level of human development in the country, within the framework of Fiscal Responsibility Legislation. At the same time, issues relating to the quality and timeliness of providing such social sector services need to be expeditiously addressed.

From the Reserve Bank's standpoint, initiatives relating to credit culture, financial literacy, financial inclusion and priority sector lending would continue to remain high on the policy agenda.

Concluding remarks

RBI has considerable professional skills and the States recognise and value them better when we are willing to consider State-specific orientation to our broader analysis. The RBI, like most of the central banks, commands considerable credibility and good public image and as a public institution is considered relatively apolitical in viewing the vertical relations between the Centre and the States and horizontal ones amongst the States. The bi-annual Conference of the State Finance Secretaries sponsored by the RBI has proved to be an excellent forum for wide-ranging discussions. The Technical Committees or Groups that are formed, have membership entirely from the States, though Centre may occasionally be associated, but RBI provides secretarial and technical support. The Centre and each State concerned decides the appropriate course of actions. The fact that some of the States have adopted a few but not all the recommendations of the Committees and Groups, demonstrates the shift away from the perceived centralisation of the past towards a participative process.

I am happy to submit that all the States, though with varying degrees of enthusiasm, fully endorse the immense contribution of the process of partnering between RBI and the States in the cause of better financial sector and fiscal empowerment in the States.

Let me conclude with profuse thanks to the Madras School of Economics for provoking me to think aloud on this subject and share the thoughts with wider audience.

The School came into existence in 1995, but very soon, it could obtain "A" Grade from the National Assessment & Accreditation Council. The Ministry of Environment and Forests has also designated the school as a Centre of Excellence in Environmental Economics.

I have no doubt that the School would emerge to be an internationally recognised Centre of Excellence in economic studies attracting the best of students and teachers from different parts of the country as well as other countries.

On our part, we in the RBI are in close touch with the School with a view to obtaining their expertise in the process of monetary policy formulation.

Thank you.