Fiscal issues and central banks in emerging markets: an Indian perspective

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1. The Indian fiscal system

Under India's federal system of government, the constitution allocates the revenue powers and expenditure functions between the central and state governments. In general, the functions required to maintain macroeconomic stability and international relations are assigned to the centre, while provision of public services such as law and order, internal security, public health, sanitation, water supply and agriculture is largely entrusted to the states. Both government layers share responsibility for education, health and infrastructure. Until the constitutional amendments of 1992, those levels of government below the state level, the local governments in both urban and rural areas, were not mentioned in the constitution.

In the planning system adopted in India in 1951, almost all the investment programmes of government departments, public sector enterprises and other public authorities are covered within a five-year plan framework. The Planning Commission, an apex body set up for approving five-year and annual plans, makes budgetary allocations for direct investment by government departments, equity and loan injections to public sector enterprises, government budgetary subventions and loans to other authorities.

The non-statutory Planning Commission also determines the size of resource flows from the centre to finance state plans as part of the approval process for five-year plans, and the distribution of the total amount of central assistance among the states is determined on the basis of an established formula. However, the actual allocation is made on an annual basis taking account of the fiscal situation of the central and state governments and factors such as availability of resources for funding plan projects, states' own resources, and the need for development of certain sectors and regions. The criteria considered for the distribution of central assistance for plans include population, per capita income, state-specific problems and fiscal management.

For reasons relating to the efficiency and ease of tax collection, the constitution assigns a number of important tax resources to the central government and a limited amount of tax resources to the states. The relationship between state governments and local authorities also exhibits a similar imbalance. Recognising the imbalances, the constitution provides for a Finance Commission, an independent quasi-judicial body constituted every five years, to recommend allocations of central taxes to the states. It also forecasts the revenue and expenditure of the state governments and recommends additional assistance in the form of grants-in-aid to close the resource gap.

A third component of transfers from the central government to the states is specific purpose grants under various centrally sponsored schemes. These grants are awarded to the states to undertake certain agency functions and are therefore entirely financed by the central government. Centrally sponsored schemes are initiated for services falling within the state's jurisdiction to ensure that optimal levels are provided. Essentially, the various modes of resource transfer from the centre to the states are intended to eliminate vertical as well as horizontal fiscal imbalances.

The planning process has governed the system for investment activities in India. For both the central and the state governments, the Planning Commission attempts to devise, through a process of extensive consultations, a financing programme for the whole plan investment programme. There is a variety of sources financing the central government's fiscal deficit, including balances from current revenues, contributions from public sector enterprises, bonds issued by public sector enterprises, market loans, small savings (retail savings made in fixed return schemes administered by the government and post offices), provident funds and capital receipts from previous lending operations.

The constitution requires states to obtain the consent of the central government for raising any loan if there is any loan outstanding to the central government. State plans are financed from the following sources: current revenues, contributions from state public enterprises, domestic borrowing by states (market borrowings, small savings and provident funds) and central assistance. Of these sources, the market borrowing and small savings components affect the central bank's balance sheet most directly, in terms of their impact on liquidity and interest rates.

Role of the Reserve Bank of India in the Indian fiscal system

The Reserve Bank of India (RBI) plays two crucial roles in relation to the Indian fiscal system, namely as banker to and debt manager of both central and state governments. These roles are derived from the Reserve Bank of India Act 1934 and Public Debt (Central Government) Act 1944. The RBI is *required* to undertake, accept and pay out monies on behalf of the central government up to the amount standing to the credit of its account and to carry out its exchange, remittance and other banking operations, including the management of public debt. The RBI Act *allows* the RBI by agreement with a state government to undertake its banking operations and management of its public debt.

While undertaking the role of banker for both the central and state governments, the RBI also provides temporary support to tide over mismatches in their receipts and payments in the form of Ways and Means Advances (WMA). Prior to April 1997, the RBI's accommodation of the central government was extended against ad hoc Treasury bills. This provision for extending short-term financing (not exceeding three months) was intended to bridge temporary mismatches in cash flows. Unfortunately, the central government slipped into the practice of rolling over this facility, resulting in automatic monetisation of the government's deficit. The process of creating 91-day bills and subsequently funding them into non-marketable special securities at a very low interest rate (4.6%) emerged as a principal source of monetary expansion. In addition, the RBI also subscribed to the primary market issuance of government securities. As a consequence, net RBI credit to the central government increased from about three quarters of the monetary base during the 1970s to over 90% during the 1980s. It was only in the 1990s that some restraint was consciously exercised on monetisation. In 1994, limits were set on the automatic monetisation of the government deficit by the central bank. In April 1997, a new WMA scheme was introduced on the basis of an agreement signed by the central government and the Bank in 1994. Accordingly, the Bank sets limits on the use of WMAs. The limits fixed for 2002/03 were INR 100 billion for the first half of the year (April-September) and INR 60 billion for the second half (October-March), which was the same as in 2001/02. The absolute limits fixed for 2001/02 translated into about 17% and 8% of the gross fiscal deficit in the first and second half of the year, respectively. In the case of state governments, the RBI provides two types of WMAs. Normal WMAs are clean or unsecured advances extended at the Bank rate, while special WMAs are extended against the pledge of central government securities and Treasury bills held by state governments. Until recently, WMA limits were linked to the cash balances the states maintained with the RBI. However, since 1999/2000 the WMA limits have been determined on the basis of a three-year average of revenue receipts and capital expenditure.

Review of fiscal developments

The government sector plays a major role in economic activities in India. The share of (central and state) government expenditure in GDP rose steadily from around 12% in the 1950s to 20% in the 1970s and further to 29% in the 1980s. However, it declined marginally to 27% in the 1990s. Government sector revenue increased over the decades from 9-12% of GDP in the 1950s and 1960s to 15% in the 1970s and 19% in the 1980s. However, it declined to 18% in the 1990s.

The central and state governments had maintained surpluses in their revenue account during the first three decades after independence. However since the 1980s, the major deficit indicators have shown steady deterioration, reflecting an acute resource crunch. The revenue deficit of the government sector, which was barely 0.4% of GDP in 1980/81, rose sharply to 4.2% in 1990/91. Overall revenue growth rose from 15.3% of GDP in the 1970s to 19.0% in the 1980s, but the rise in expenditure was even higher, almost 9 percentage points from 20.1% of GDP to 28.8%, during the same period. Consequently, the gross fiscal deficit, which reflects the overall borrowing requirement of the government sector, rose sharply to 8.5% of GDP during the 1980s from around 5% in the 1970s. This sharp rise in the resource gap culminated in sharp growth of the public debt, posing a severe threat to macroeconomic stability. The combined fiscal deficit constituted 9.4% of GDP in 1990/91.

This deterioration in the fiscal situation and the need to finance the government led to increased repression of the financial system in the 1980s. The high levels of public borrowing forced the RBI to keep the level of both the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR) high for the banking system. The CRR was raised continuously from 7% in the early 1980s to 15% by 1989. The SLR was also inceased continuously from 34% in the early 1980s to 38.5% in 1990. The banks then needed to charge higher interest rates to the rest of the economy. Further, the prevalence of small savings schemes at administered rates impeded the development of the financial markets and led to rigidities in the interest rate structure. To address these issues, fiscal restructuring and financial sector reforms were included in the economic reform programme initiated in the early 1990s.

Following the fiscal correction measures, the fiscal deficit declined progressively from 9.4% of GDP in 1990/91 to 6.4% in 1996/97. This pace of change, however, could not be sustained. While government expenditure was brought down from 28.8% of GDP in the 1980s to 27.1% in the 1990s, there was a steady decline in the tax/GDP ratio from 15% in the 1980s to 14.6% in the 1990s. The gross tax revenue of the central government declined to 8.8% of GDP during 1999/2000 from 10.6% in 1989/90. Similarly, state tax revenue declined from 8% of GDP in 1989/90 to 7.5% in 1999/2000.

Fiscal activism as reflected by a mounting fiscal deficit and the nature of its financing influence inflation, interest rates, exchange rates and private sector behaviour. Excessive bond financing of the fiscal deficit leads to pressure on credit in the domestic market resulting in upward pressure on real interest rates. The monetary financing of the deficit results in growth in primary liquidity, which leads to large monetary expansion and the possibility of generating inflationary pressure. The excess deficit may spill over into the current account deficit if the government depends on a larger external source of funds for financing the deficit, assuming neutrality in private saving/investment. Fiscal imbalances also tend to influence private investment either by pushing up interest rates or directly consuming resources.

2. Impact on monetary policy

Fiscal policy and monetary policy are the two arms of macroeconomic policy, aimed at growth, equity and macroeconomic stability. While fiscal and monetary policy have common objectives, the instruments used differ. Fiscal policy rests upon instruments such as government expenditure, taxes and borrowing. Monetary policy influences the level of economic activity through actions that impinge on the cost of funds and the availability of overall liquidity in the system. Effective macroeconomic management presupposes a well-knit and coordinated fiscal and monetary policy environment, since fiscal policy continues to have a close bearing on the conduct of monetary policy. A high fiscal deficit impedes the effective use of monetary policy instruments.

In the Indian context, the fiscal operations of the government had a dominant effect on monetary policy until recently. Prior to the early 1990s, the financial markets in India were highly segmented. The money market lacked depth, with only the overnight interbank market in place. Interest rates in the government securities market and the credit market were tightly regulated. The dispensation of credit to the government took place through the SLR requirement whereby the commercial banks were made to set aside substantial portions of their liabilities for investment in government securities at below market interest rates. Furthermore, credit to the commercial sector was regulated, with prescriptions of multiple lending rates and a prevalence of directed credit at highly subsidised interest rates. The main instruments of monetary policy were reserve requirements, quantitative control of bank credit, administered interest rates and finance (by repos) to commercial banks.

In the wake of the mounting fiscal deficit, the scale of government borrowings remained high. The ad hoc Treasury bills created automatically to finance the central government deficit without any limit resulted in rapid monetary expansion when the deficit became very large. In such an environment, monetary policy had to neutralise the inflationary impact of the growing deficit. The resources of the banking sector came to be increasingly absorbed to support the government’s borrowing and to contain the inflationary impact. The situation led to the gradual scaling-up of the CRR and the SLR to 63.5% in 1991 from only 23% in 1962. Required lending to priority sectors accounted for up to 40% of the remaining bank credit.

Government control over organised credit was enlarged with the nationalisation of commercial banks in 1969. After nationalisation, the administered interest rate regime in India was characterised by cross-subsidisation: credit to priority sectors was accorded interest rate concessions and this was compensated by high interest rates on advances to non-priority sectors. The regulation of interest rates on loans also led to the regulation of deposit rates. With the proliferation of directed credit arrangements, multiple interest rate prescriptions based on a variety of criteria, such as economic activity, type of commodity, location, type of borrower group, and the resultant cross-subsidisation created a complex administered interest rate structure with virtually no role for market forces in the pricing and allocation of credit.

Besides RBI support and other domestic market borrowings, another means of financing a government deficit is the funds raised under public accounts, consisting mainly of small savings and provident funds, which attract high interest rates. Investments in these instruments also enjoy tax incentives, which enabled the government to garner sufficient funds to close the resource gap. The regulation of interest rates on small savings created distortions in the interest rate structure as well as in allocative efficiency. Furthermore, the integration of financial markets remained weak due to the rigidities in the administered interest rates.

Reforms in the 1990s

The 1990s were characterised by fundamental changes in monetary/fiscal coordination as part of the macroeconomic reform programme. This was largely facilitated by the conscious efforts of the government to launch a comprehensive programme of economic reform in July 1991 with fiscal correction as its key element. The agenda of fiscal correction focused on both tax reform and expenditure management. Reforms in taxation concentrated on the progressive reduction of tax rates, the rationalisation and simplification of tax laws, and effective tax compliance. The focal point in expenditure management was the containment of non-plan expenditures in order to enhance public spending in productive sectors and thereby to provide a stimulus to economic growth. Although the progress in reducing the fiscal deficit was interrupted and even suffered a reversal, the fiscal retrenchment experienced facilitated a more conducive environment for undertaking some path-breaking measures to strengthen fiscal/monetary coordination as well as financial sector reform.

Interest rate deregulation

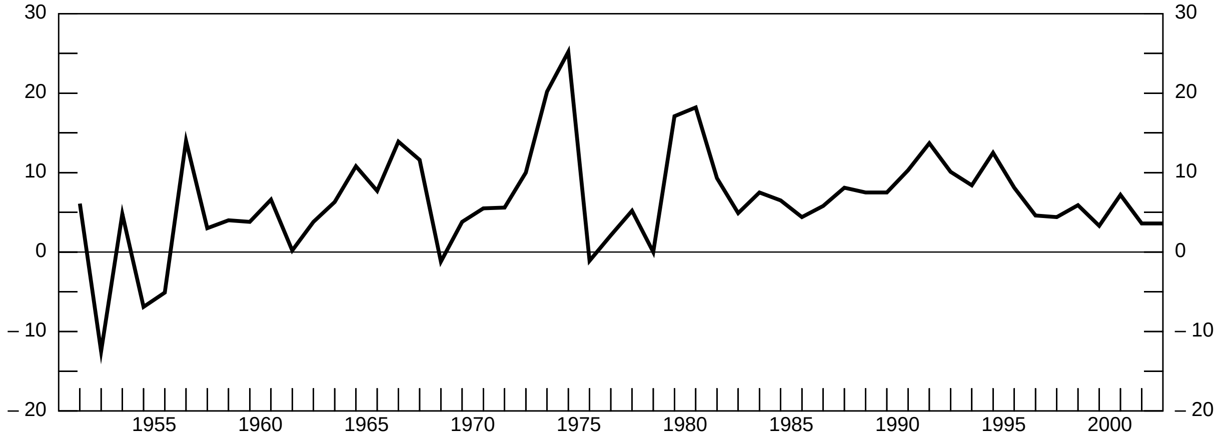
The structure of administered bank interest rates has been progressively dismantled over the years. On the deposit side, prescriptions on rates, including the conditions governing premature withdrawal, and uniformity of rates between depositors irrespective of size of deposits, have been removed. At present, the lone regulation relates to the savings bank interest rate, which has been fixed at 4% since 1 April 2000. On foreign currency non-resident bank deposits, there is an interest rate ceiling of Libor minus 0.25%. Lending rates for different categories have also been liberalised. In the interest of transparency, banks are required to declare their prime lending rates (PLR), but lending at sub-PLR has been permitted. Prescriptions, however, still remain on loans up to INR 0.2 million and for export credit, both linked to the PLR. Banks are also permitted to accept deposits or lend on floating interest rate terms. Reforms in the small savings segment are making interest rates more flexible. Initially, the interest rates on such small loans have been reduced in alignment with market interest rates. The government has announced a broad decision to link small savings interest rates to yields on government securities of similar maturity, which reflect market rates of interest.

Containment of inflation

Inflation (measured by the wholesale price index) over the past fifty years has averaged 6.5%; reasonably satisfactory compared to many developing economies. The inflation rate was fairly low (averaging 1.2%) during the 1950s, although it exhibited substantial volatility. Inflation, however, increased to 6.4% during the 1960s, reflecting a variety of factors such as the two wars (1962 and 1965) and famine conditions (1965-67). Reflecting the impact of the supply shocks emanating from movements in crude oil prices (1973-74 and 1979-80) and crop failure (1972-73), inflation and its volatility both increased during the 1970s: while the inflation rate averaged 9.0% during the 1970s, the standard deviation too was 9.0%. The average inflation rate in the 1980s declining only marginally to 8.0%; attributable to demand pressures deriving from a pickup in growth, partly stemming from the widening fiscal imbalances and the resultant monetary financing. The volatility (standard deviation), though, declined to 3.9% during the 1980s. The second half of the 1990s were marked by a significant fall in inflation to an average 5.3% due to macroeconomic stabilisation and structural reforms pursued during the decade. Inflation was down to almost 1% during 2002 but back to 6% in early 2003.

Graph 1

Inflation in India[1]



[1] Annual percentage change in the wholesale price index.

Source: National data.

Elimination of automatic monetisation

A fundamental step during the reform period to strengthen fiscal/monetary coordination was the signing of an agreement between the central government and the RBI in 1994 to replace the automatic monetisation of the budget deficit by the WMA system to finance temporary government mismatches within a ceiling. Under the new system, the RBI was required to set the limits on WMAs to the government with effect from April 1997. When 75% of the WMA limit is utilised by the government, the RBI may trigger a fresh flotation of market loans depending on market conditions. Any amount exceeding the WMA limits is treated as an overdraft. Overdrafts are limited to 10 consecutive working days. The interest rate on WMAs is the Bank rate, and on overdrafts, the Bank rate plus 2 percentage points. Until recently WMA limits for state governments were linked with the cash balances the states maintained with the RBI. However, since 1999-2000 the WMA limits are determined on the basis of a three-year average of revenue receipts and capital expenditure.

Development of the government securities market

The government securities market is a core constituent of the Indian financial system. Since 1991, a number of measures have been taken by the RBI for widening and deepening the market. With the switch in 1992 to borrowings by the government at market-related interest rates through an auction system, and more recently the abolition of the system of automatic monetisation, it became possible to progress towards greater market orientation in government securities. Depth, liquidity and transparency were added to the market by reforms such as;

- introducing new instruments across the maturity spectrum (zero coupon bonds, floating rate bonds, capital-indexed bonds, bonds with call and put options),
- establishing a system of delivery versus payment, the introduction of primary dealers with liquidity support and incentives for underwriting,
- authorising foreign institutional investors to invest in dated securities and T-bills in both the primary and secondary markets,
- announcing an auction calendar for T-bills and dated securities,
- Clearing Corporation of India Ltd commencing operations,
- introducing a negotiated dealing system, and
- the dissemination of online market information.

Furthermore, these reforms have facilitated the switch to indirect tools of monetary management by the RBI through open market operations and repos.

In the initial years of financial sector reform, considering the market perception and the period of transition from preannounced coupon to market-related rates, the maximum maturity on government securities was reduced from 20 to 10 years. This led to a bunching of redemptions in the first few years. In order to avoid this bunching and frequent rollovers, in recent years efforts have been made to elongate the average maturity of central government bonds. The maximum maturity of fresh primary issuances was raised from 10 to 20 years in 1998/99 and then to 25 years in 2001/02 and further to 30 years in 2002/03. Accordingly, the weighted average maturity of public debt for the central government rose from 5.5 years in 1996/97 to 14.3 years in 2001/02. Steps such as consolidating issuances in key maturities, enhancing fungibility and liquidity through the reissue of existing loans and promotion of the retailing of government securities have made the long-term rates more market-related. They have also provided an enabling environment to create a suitable benchmark for pricing various debt instruments catering to the needs of long-term investors. Consequently, the yield on 10-year central government securities is evolving as a long-term benchmark rate.

The wider market participation in the government securities market has obviated the need for the government to depend predominantly on RBI credit for financing the fiscal gap. With concomitant reforms in the money market, such as development of the repo market and the introduction of a liquidity adjustment facility, the interest rate transmission channels of monetary policy have attained greater effectiveness in the recent past. Moreover, currently, the RBI's participation in the government debt market through both primary and secondary operations is part of its overall monetary management consistent with the monetary stance as compared with automatic monetisation until the early 1990s.

Fiscal policy rules

Explicit fiscal rules on deficit and debt, as prevailing in advanced countries, are still evolving in India. The budget process, however, implicitly involves some controls on spending and borrowing. For instance, the size of the deficit, level of expenditure and borrowings are approved by the relevant legislature as part of the annual budget for both the central and the state governments. Similarly, limits are placed on the borrowing powers of the central and state governments, under the provisions of Article 292 and 293 respectively of the Indian constitution. Their WMAs from the RBI are also limited. Moreover, comprehensive legislation, namely the Fiscal Responsibility and Budget Management Bill 2000, is being contemplated by the central government, which would provide the legal and institutional framework to lower fiscal deficits, contain the growth of public debt and prohibit direct borrowings by the central government from the RBI, except by temporary advances.

3. Current issues

Fiscal stress

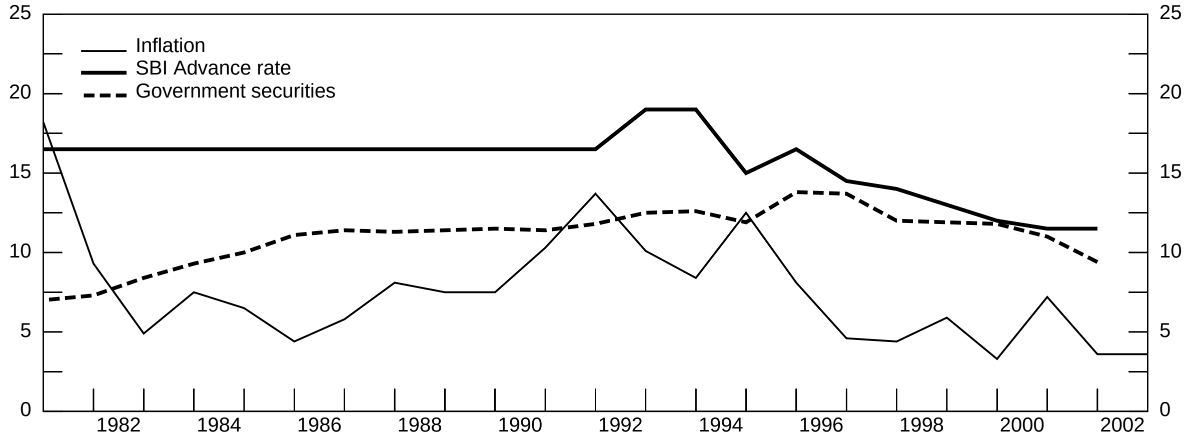
Many economies are confronted with persistent fiscal imbalances, which are structural and difficult to address. In India, fiscal imbalances arise from the government's inability to raise adequate revenues to meet growing expenditure. Being the banker to the government, the RBI is often required to provide temporary financial support in the form of WMAs. Such accommodation on a continuous basis would be a potential threat to monetary management by the central bank. Moreover, being the debt manager for both the central and state governments, the RBI needs to strike a balance between short-run liquidity management and cost-effective public debt management

High real interest rates

In India, fiscal dominance persists with a growing volume of gross market borrowings despite some improvement in monetary/fiscal interference. The RBI's endeavour has, therefore, been to ensure that the fiscal gap is financed in the least disruptive way since conduct of monetary policy without sensitivity to fiscal realities will be counterproductive. However, for macroeconomic stability, the sustainability of the real interest rate is critical. Past experience shows that the rise in the real interest rate on government bonds was mostly due to the high combined government sector deficit. With markets becoming increasingly integrated, the demand pressure on the bond market has repercussions for the entire structure of interest rates in the economy.

Graph 2

Nominal interest rates and inflation[1]



[1] In percentages.

Source: National data.

Notwithstanding that long-term rates have become more market-related, the effect in terms of fiscal discipline is not yet visible, since the market borrowing programme is predetermined and there is no feedback effect on fiscal discipline. Being both the debt and monetary manager, the RBI adopts a conscious strategy of private placement/devolvement of government securities, in line with the monetary stance. In case the liquidity conditions in the market are not appropriate for a market issue or in the event that the market is expecting unreasonably high yields from primary offerings as reflected in bids received, the RBI may resort to private placement/devolvement of securities which it offloads subsequently when the market conditions stabilise.

State finances

The states' fiscal outturn significantly affects India's overall fiscal performance, as they account for about 40% of India's gross fiscal deficit. The state governments' fiscal deterioration, especially since the second half of the 1990s, has reflected inadequate revenue and growing expenditure. Broadly, the issues of concern to the RBI relating to state finances are:

- the need for successful completion of the market borrowing programme of the states, with the RBI acting as debt manager, without causing undue pressure on the market;
- the RBI's role as banker to the state governments; and
- the considerations of the RBI as monetary authority regarding financial stability. The last factor assumes critical importance, especially in view of the increasingly significant exposures of banks and financial institutions to state government paper.

The RBI has undertaken many initiatives in recent years to address these issues. First, in order to provide better managed states with greater flexibility to access funds at more favourable rates, an option has been given to the state governments since 1997/98 to raise between 5 and 50% (initially 35%) of their market borrowings through the auction process. Second, to facilitate timely debt servicing by state governments, the RBI has been making the state governments aware of the benefits of setting up consolidated sinking funds, and a number have done so. Moreover, the Technical Committee on State Government Guarantees (1999), set up by the RBI, recommended limiting guarantees, greater selectivity in providing guarantees and the creation of a contingency fund for guarantees. The RBI has also advised banks and financial institutions to eschew any proposal for financing government budgets, directly or through special purpose vehicles. With effect from 2000/01, investment by banks in state government securities outside the market borrowing programme attracts a risk weight of 20% for the purpose of provisioning. In case of default, such investments are to be treated as non-performing assets and a 100% risk weight is to be attached with adequate provisioning. In view of the fiscal implication of the rising level of guarantees, some states have taken the initiative to place ceilings on guarantees. Like the central government, certain states have initiated or proposed statutory backing of the fiscal reform process through enabling legislation relating to the size of the deficit, a limit on the outstanding stock of debt and the use of borrowed funds. The state of Karnataka has already passed a fiscal responsibility bill.

Separation of debt management

With the large fiscal deficit experienced in recent years and the consequent large market borrowing programme of the government, there has for many years been an overarching influence of debt management policy on monetary policy. The extensive monetisation of the fiscal deficit and borrowings at lower than market-determined interest rates significantly affected the effective functioning of monetary policy. In the process, the monetary policy function became somewhat subservient to debt management. This is compounded by the fact that the RBI statutorily acts as the fiscal agent of the government in managing the public debt. Assigning the debt management policy function to the RBI confronts the RBI with a direct dilemma between debt management and monetary policy. The planned Fiscal Responsibility and Budget Management Bill Act, inter alia, clearly delineates the responsibilities of fiscal policy and monetary policy.

To sum up, the RBI has been reiterating the need for fiscal empowerment by augmenting the volume and scale of revenue (both tax and non-tax) flowing into the budget. Revenue maximisation requires that the tax system be reformed through a widening of the tax base, simplification of tax rules, review of exemptions/incentives and strict tax compliance to arrest the declining trend in the tax/GDP ratio experienced through the 1990s. The RBI has also been emphasising the need to adopt a comprehensive approach to the management of public expenditure, which requires explicit recognition of the macroeconomic linkages of government expenditure policies, the setting of expenditure priorities and ensuring that specified activities are being undertaken efficiently and effectively.