Sovereign debt management and the central bank: an emerging market perspective

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Global rethinking and post-crisis lessons

In the past, the functions of sovereign debt management (SDM), monetary policy and financial stability have often been looked upon as an 'impossible' duality or trinity. Post-crisis, their interdependence is increasingly being recognized. In the developed world, central banks' operations are now extended to the long end by way of quantitative easing and open market operations. Similarly, government debt managers are also operating at short end. This has intensified the interaction between SDM and monetary/financial stability operations, warranting greater coordination for the purpose of policy credibility.

Designing an effective coordination mechanism between the debt management office (DMO) and the central bank, however, remains a challenge. In many countries, lack of proper coordination has resulted in competing auctions and in market confusion regarding the true signals of monetary policy (Das et al, 2010). Thus, government bond auctions have at times failed to mobilise the notified amount in many countries, including the UK, Germany, China, Netherlands and Hungary, leading to reputation risk for both the DMO and the central bank.

Historically, SDM has been one of the primary functions of central banks. With the creation of the European Central Bank, the establishment of independent and autonomous DMO was encouraged in the euro area. In the background of the European sovereign debt crisis, the concern regarding short-term/foreign debt has been highlighted as contributing to rollover risk, sovereign risk and financial instability. We should not, however, lose sight of the fact that, while institutional arrangements for SDM are important, they are a poor substitute for a stronger fiscal health.

SDM has since shifted back to the central bank in Iceland in 2007, as happened in Denmark in 1991. In Canada, SDM continues to be handled by the central bank jointly with the Ministry of Finance, while the plan to separate SDM from the central bank has been abandoned in Kenya, Zambia and Sri Lanka. The pre-crisis framework of a single objective and single instrument for the central bank, which was the foundation for the separation of SDM and monetary/financial stability functions, is no longer the mainstay. Central banks are now being entrusted with multiple responsibilities even in the developed world, in view of a confluence of interests far outweighing perceived conflicts. In this context, Goodhart (2010) has advocated restoring SDM responsibility to the central bank.

Indian experience

Collaborative management of SDM and monetary/financial stability is critical for emerging markets like India, given the stage of financial development, the limited absorptive capacity

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of the financial market and the high fiscal deficit. In this regard, CGFS (2011) has observed that ''In developing systems, where the central bank might also issue debt for sterilization purposes or manage government-related cash balances, policy coordination has been more common, including some cases where the central bank is responsible for some SDM functions or involved in SDM oversight.'' At present, the SDM operations in the Reserve Bank of India (RBI) are carried out by the Bank's Internal Debt Management Department (IDMD), which is functionally separate from monetary management. The SDM strategy is formulated by the Monitoring Group on Cash and Debt Management, which is the apex entity for coordination between the RBI and the Ministry of Finance.

Given the magnitude of government borrowing, SDM is much more than a resource-raising exercise in India. The extent and dynamics of government borrowing have a much wider influence on interest rate movements, systemic liquidity and credit growth through crowding out. SDM therefore must be seen as part of broader macroeconomic management, involving various tradeoffs. Once this is recognized, the centrality of central banks in this regard becomes quite evident. Only central banks have the pulse of the market and the instruments needed to make contextual judgments that would be difficult for a DMO driven by narrow objectives (Subbarao, 2011).

With the Fiscal Responsibility and Budget Management (FRBM) Act, the basic source of conflict between SDM and monetary policy has been removed in India, as the central bank is precluded from subscribing in the primary market. The central bank's interest rate signalling is performed by the repo rate under the Bank's Liquidity Adjustment Facility (LAF) rather than by the primary market yield, which is auction driven. In line with the IMF-World Bank's guidelines, the central bank as debt manager strives to minimize cost of borrowing over the medium term as well as the rollover risk of debt. Thus, with the average maturity of federal government debt at around 10 years, India has one of the longest maturity profiles in the world, which proved to be a source of strength and comfort during the crisis. A higher domestic saving rate, coupled with calibrated capital account management and liquidity ratios for financial intermediaries (along the lines of Basel III), has made largely domestic holding of government debt possible, insulating SDM from potential volatility from foreign holding.

Contrary to popular perception, the debt manager is supposed to minimise cost over the medium term, rather than the immediate cost, in view of the rollover risk. Therefore, SDM by the central bank need not necessarily be in conflict with monetary management. Indeed, we look upon price stability as the core of debt management, without which it would be difficult to sell fixed coupon bearing instruments like government securities. Price stability since the mid-1990s has facilitated the lengthening of the sovereign yield curve up to 30 years in India. Thus a central bank in charge of SDM could be equally committed to price stability, particularly when SDM is its statutory responsibility. Moreover, the central bank, through its numerous development measures for widening and deepening the market, is focused upon the cost of government borrowing over the medium term. The system in place for trading, payment and settlement in India, namely the Negotiated Dealing System (NDS), NDS-OM (NDS-Order Matching), Delivery versus Payment III, Real Time Gross Settlement (RTGS) and Straight-Through Processing (STP), is world class. The multi-pronged initiatives for development of the government securities market have also facilitated monetary transmission and made it possible to pursue indirect as opposed to direct instruments of monetary control. As inflationary pressures surfaced, the central bank did not hesitate to signal interest rate hardening, despite large government borrowing requirements (eg an increase in the repo rate on 13 occasions since March 2010).

In a situation of excess capital inflows/outflows requiring forex intervention and sterilization/unwinding through Market Stabilisation Scheme (MSS) bonds, SDM needs to be integrated with these operations. In 2007-08, the volume of MSS issuance was comparable to that of SDM issuance in India. With the reversal of capital flows in 2008-09 and the large increase in the government's market borrowing programme, there was significant unwinding of the MSS, and the Reserve Bank was able to manage the situation non-disruptively by carrying out liquidity management seamlessly, as both functions are entrusted to it. We can expect that volatility in cross-border capital flows will continue on a global basis, and hence we need to continue using MSS as required.

The cash management of the government interfaces closely with monetary policy and financial stability on a day-to-day basis. The debt manager should strive to maintain a stable cash balance with the central bank, avoiding absorption/injection of market liquidity, which may not be in tune with the monetary policy stance. Success in doing so, however, critically depends on the commitment/efficiency of various government departments in managing their cash flows. To incentivise the process, government cash balances, if any, may be remunerated up to a limit. Auctioning of government cash balances when the market has a liquidity surplus is best avoided in the interest of stabilisation and the central bank balance sheet. Furthermore, recourse to central bank money for intra-year requirements of the government needs to be limited as leading to the creation of primary liquidity.

In the Indian context, the SDM of provincial governments, currently being performed by the central bank, adds another dimension. It is imperative to harmonise the SDM of the federal and the provincial governments, as the latter has reached a critical mass vis-à-vis the absorptive capacity of the market. Assigning a countercyclical role to the sub-sovereign governments also calls for greater coordination and information sharing with the monetary and financial stability authorities. Also, bearing the federal polity in mind, the provinces' sensitivity to entrusting SDM to an agency of the federal government needs to be considered.

The smooth conduct of the government's huge borrowing programme in recent years has been facilitated by the RBI's having a broad range of responsibilities – regulation and surveillance of financial markets in general and the government securities market in particular under the RBI Act and the Government Securities Act, oversight over market infrastructure (eg Clearing Corporation of India Limited) for government securities and money market instruments, custodial functions, responsibility as banker and debt manager to both federal and provincial governments, thus calibrating debt issuances as a function of market conditions, determining what instruments will be offered to the market and their timing, handling of institutional matters and interactions with investors, and consideration of investors' risk constraints at every point in time – all of which affect financial stability. This is also very relevant since the banks are predominant investors in government securities, and the Reserve Bank as the regulator and supervisor of the banking system has hands-on experience with the functioning of banks.

Summing up

Following fiscal consolidation during 2003-07, a Middle Office for debt management was set up in the Ministry of Finance in 2008. The Union Budget (2011-12) has now proposed to introduce the Public Debt Management Agency (PDMA) of India Bill during 2011-12 as a step towards establishing an independent DMO. It may be recalled that the RBI itself termed the separation of SDM from monetary management a desirable medium-term goal as early as 2001. However, the recommendation was qualified by three preconditions: (i) development of the government securities market, (ii) durable fiscal correction and (iii) an enabling legislative framework. In the context of global crisis, the government had to carry out a countercyclical role, leading to a high fiscal deficit and large market borrowings. Further, the issue of SDM is now being rethought globally. The emerging post-crisis wisdom recognizes the interdependence of functions linking monetary policy, financial stability and SDM, and the need for a close association of the central bank with SDM. The foregoing assessment regarding the issue of SDM needs to be seen in this light.

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