Sovereign debt management in India: interaction with monetary policy

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Abstract

India's expansionary fiscal policy during the recent crisis resulted in higher government borrowing through 2008–09 and 2009–10. This borrowing requirement came in about 83% above the budget estimate in 2008–09, and 65% above the previous year in 2009–10. The debt-to-GDP ratio rose from 69% before the recent global financial crisis to 73% in 2010, creating a severe challenge for the Reserve Bank of India (RBI) in meeting the public borrowing requirement without causing market disruption. To hold borrowing costs down while scheduling issue maturities so that rollover risk was kept to a minimum, the RBI followed a multi-pronged strategy.

The potential for interaction between public debt management and monetary policy has undoubtedly increased during the recent global crisis. This is due to the increase in short-term debt, which can jeopardise both the signalling of monetary policy and its transmission. India's particular dilemma, however, was related to systemic liquidity, ie the system would preferably be in deficit for monetary policy transmission whereas a system in surplus would be more favourable for debt management. The RBI has resolved this dilemma by putting in place a monetary policy operating framework whereby the system is ideally allowed to be in deficit (or surplus) to the extent of the frictional component ie 1% (+/-) of the banking system's net demand and time liabilities (NDTL). In this setup, the structural liquidity deficit (or surplus) is met through OMOs and adjustments in the cash reserves.

Against the background of the increased interaction between sovereign debt management (SDM) and monetary policy, two important issues urgently need to be addressed. These are: (i) to ensure seamless coordination between SDM and monetary policy, especially during turbulent periods; and (ii) to revisit the role of central banks in public debt management.

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Sovereign debt management (SDM) is important for other macroeconomic policies, especially monetary policy setting and transmission. The recent global crisis has brought sovereign debt to the forefront as debt surged to unsustainable levels in many advanced countries, triggering sovereign debt crises. Reinhart and Rogoff (2011) find that, for countries with systemic financial crises and/or sovereign debt problems (Greece, Iceland, Ireland, Portugal, Spain, the United Kingdom and the United States), average debt levels are up by about 134% since 2007, surpassing by a significant margin the three-year 86% benchmark that the same authors (2009) find for earlier deep post-war financial crises.[2] These debt levels have posed severe challenges for other macroeconomic policies and objectives. Some central banks, especially in advanced countries, have applied unconventional monetary policy measures, ie outright purchase of long-term government bonds to influence long-term interest rates. However, the success of such measures has yet to be proven. Nevertheless, a broad consensus has emerged in academia and among policy practitioners on the importance of coordination between debt management and other macroeconomic policies, especially monetary policy.

The sovereign debt composition in terms of maturity, instruments and currency could also have grave implications for other macroeconomic policies. For instance, heavy government borrowing combined with the outright purchase of government securities by central banks has heightened the interaction between monetary policy and SDM. Rising sovereign default risks and increased volatility in markets for government securities have serious implications for financial markets and financial stability, given that government securities constitute a large part of banks' and financial institutions' portfolios.

India's debt-to-GDP ratio rose from 69% before the recent global financial crisis to 73% in 2010. This increase was mainly due to India's fiscal stimulus measures, which were similar to those implemented by sovereigns worldwide after the financial crisis. This note covers the various issues arising from the Indian experience with public debt management and the challenges it poses to monetary policy.

Public debt management framework

The Reserve Bank of India (RBI) is responsible for managing India's public debt, especially debt denominated in the domestic currency. The management of the central government's debt is conducted by RBI under statutory provisions that oblige the central government to delegate its debt management to the RBI. The debt of the sub-national governments, on the other hand, is managed by the RBI under bilateral agreements. The RBI seeks to hold the government's borrowing costs to a minimum over the medium to long term, while keeping the associated risks to a prudent level. The cost objective is largely met by deepening and widening the government securities market, while rollover risk is contained by fixing upper limits for yearly maturity buckets as well as individual securities. These limits are set according to the government's repayment capacity and the probable demand for government securities. Further, the maturity of each new issue of government debt is influenced by the interest rate cycle; shorter maturities are considered when the yield curve is steep and vice versa.

Two landmark developments have shaped India's public debt management framework, namely (i) the March 1997 supplemental agreement between the RBI and the government

[2] The combination of high and climbing public debts (a rising share of which is held by major central banks) and the protracted process of private deleveraging makes it likely that the 2008–17 period will be aptly described as a decade of debt

and (ii) the 2003 Fiscal Responsibility and Budget Management (FRBM) Act. The supplemental agreement discontinued the issuance of ad-hoc treasury bills by the government to the RBI to finance the fiscal deficit, while the FRBM Act prohibits the RBI from participating in the primary auctions for government loans. Together, these measures prevent the fiscal deficit from being monetised.

Apart from its role as debt manager, the RBI also acts as a banker to both central and sub-national governments. Thus, the RBI provides Ways and Means Advances (WMA) and limited overdrafts to both the central and sub-national governments allowing them to meet any temporary mismatch between receipts and payments. Further, the RBI acts as a fiscal adviser to both the central and the sub-national governments. For example, most of the sub-national governments have adopted fiscal responsibility legislation that was originally proposed by an RBI working group.

Debt management experience during the crisis

The expansionary fiscal policy adopted during the recent crisis resulted in higher government borrowing during 2008–09 and 2009–10. The government's gross market borrowing was estimated at INR 1,497.80 billion in the 2008–09 budget. However, actual government borrowing during 2008–09 amounted to INR 2,730 billion, about 83% higher than the budget estimate. Gross borrowing increased further to INR 4,510 billion during 2009–10 reflecting continued fiscal expansion. The challenge for the RBI was to manage a government borrowing programme on the required scale without disrupting markets, especially in an environment of uncertainty and heightened risk aversion among investors. The borrowings of sub-national governments also increased by about two thirds in 2008–09 over the previous year, as they also undertook countercyclical measures. The sub-national governments raised from the market a gross amount of INR 1,181 billion and INR 1,311 billion during 2008–09 and 2009–10, respectively.

The associated challenges need to be viewed in the context of the fiscal stimulus packages implemented worldwide after the crisis to offset falling consumption and investment. In India, the most significant challenge for the RBI was to manage the sudden large increase in the borrowing requirement during the crisis period. Second, liquidity in the system had dried up due to large capital flow reversals as foreign investors withdrew funds from EMEs. Third, uncertainty and general risk aversion in financial markets further complicated the task of the debt manager in completing the borrowing programme without disrupting markets. To meet these challenges, while also seeking to keep borrowing costs low over time and to mitigate rollover risk, the RBI followed a multi-pronged strategy that included the following elements:

- front-loading of borrowing to make use of more favourable market conditions in the first half;
- the Market Stabilisation Scheme (MSS), which was primarily used by RBI for managing liquidity infused by capital flows, was de-sequestered to partly fund the GFD alleviating pressure on fresh government borrowings;
- use of Treasury bills to partially fund the increased gross fiscal deficit;
- shortening of average maturity to lower effective borrowing costs. The average maturity of India's public debt was sufficiently long (ie 10.59 years as at end-March 2008) to allow scope for some shortening without a significant increase in rollover risk;
- continued use of the RBI's uniform price auction format to allow aggressive bidding by investors in an uncertain market environment; and

- increased communication between the RBI and market participants through press releases, meetings, and information on evolving issues and policy decisions.

The weighted average cost of borrowing through dated securities fell from 8.50% in 2007–08 to 8.23% during 2008-09 and further to 7.89% in 2009-10. The issuance of government dated securities with maturities of five years or less increased during the crisis period, with the weighted average maturity of dated securities issued during the year shortening from 14.9 years in 2007–08 to 13.81 years in 2008–09 and further to 11.16 years during 2009–10.

Interaction with monetary policy

The interaction between SDM and monetary policy operations is a topic that has attracted an increasing amount of attention from both scholars and policymakers in recent years. When the financial crisis forced a sharp rise in sovereign borrowing, debt managers in many countries (eg the euro area) shifted the maturity structure of fresh borrowing towards the short term. Issuance of short-term debt increased significantly in almost all OECD markets during the crisis period (Blommestein (2010))[3]. Hoogduin et al (2010) note that the potential for interaction between public debt management and monetary policy has risen due to the increase in short-term debt during the recent global crisis period. Sovereign debt managers generally operate over the medium to long term; but their increased short-term fund-raising could potentially come into conflict with the monetary policy transmission mechanism. Further, the greater reliance on short-term borrowing (for example, Treasury bills and cash management bills in India) could distort the yield curve in a thin market, jeopardising monetary policy signalling and its transmission mechanisms, besides having serious implications for public welfare as the yield curve is a public good.[4]

Another possible interaction between SDM and monetary policy could be through the central bank's open market operations and the new issuance of securities by the debt manager. Since the onset of the international crisis, central banks in many advanced economies and emerging markets (EMs) have purchased government bonds in the secondary market as part of unconventional monetary policies. However, the intended effect of purchasing long-term securities (open market operations) by the central bank could be offset by a concurrent decision by the sovereign debt manager to issue long-term securities. In this regard, Mohanty and Turner (2011) note that the recent central bank operations in government debt markets to influence the long-term interest rate are usually defended on the grounds that monetary easing is constrained once the policy rate approaches zero. Furthermore, the liquidity and monetary management operations of the monetary policy also interact with SDM operations as government bonds are used as collateral in open market operations and other liquidity facilities.

These potential interactions between monetary policy and SDM could be smoothened without any adverse impact through seamless coordination between the monetary policymaker and the debt manager. Such coordination, however, is more difficult when these activities are conducted by different agencies. It has been argued that independent sovereign debt managers, seeking solely to keep costs low, are tempted to prioritise their short-term

[3] The explosion in the supply of public debt happened at a time when even sovereign issuers were experiencing liquidity problem in their secondary markets.

[4] When conventional monetary policy uses policy interest rate adjustments and signalling as the instrument, central banks typically operate such that their transactions in government debt markets have only a minimal impact on yields, so as not to undermine the usefulness of the yield curve as an indicator of macroeconomic expectations (BIS (2011)).

goals. For example, the share of short-term issuances has recently increased significantly in the sovereign debt of countries such as Greece, Portugal, Ireland and Spain, where SDM has been segregated from monetary policy into a separate debt management agency. Hoogduin, et al (2010) have analysed debt managers' behaviour in the euro area, where sovereign debt is managed by independent debt management agencies, finding that debt managers are apt, in the interests of cost mitigation, to shift excessively towards short-term borrowing in response to a steepening of the yield curve or other interest rate movement. If, however, the central bank is also empowered to manage the country's sovereign debt, it is in a position to ensure seamless coordination between both activities. This kind of coordination was evident in India during the recent global financial crisis, when it became vital to efficiently manage the steep increase in government borrowing.

In India, debt management is currently carried out by the RBI's Internal Debt Management Department (IDMD), which is functionally separate from monetary policymaking. The debt management strategy is formulated by the Monitoring Group on Cash and Debt Management, which is the apex coordinating body between the RBI and the Ministry of Finance. Contrary to the popular perception of a conflict between monetary policy and debt management, there exists a strong confluence of interest in these two activities that are undertaken by the RBI. In fact, any perceived conflict of interest was resolved by two measures, namely (i) the March 1997 agreement between Government of India and RBI that discontinued the issuance of ad-hoc treasury bills by the government to RBI, which effectively put an end to the automatic monetisation of the fiscal deficit; and (ii) the 2003 Fiscal Responsibility and Budget Management (FRBM) Act, which debars the RBI from participating in the primary market auction for government borrowing. Further, the open market operations (OMO), in which the RBI purchases and sells government securities, are coordinated with the government's borrowing programme, ruling out any potential for conflict between these activities. If there is a dilemma for RBI with regard to monetary policy and debt management, it is related to systemic liquidity. That is, the system may need to be in deficit for monetary policy transmission, whereas a system in surplus would be more favourable for debt management. But RBI has resolved this dilemma by putting in place a monetary policy operating framework whereby the system is allowed to be in deficit (or surplus) to the extent of its frictional component, ie 1% (+/-) of the banking system's net demand and time liabilities. At the same time, any structural liquidity deficit (or surplus) is met through OMOs.

The perception that a conflict exists between monetary policymaking and debt management misses the point that monetary policy lies at the core of debt management. Without inflation at a low and stable level, it would be very difficult to sell fixed coupon government securities, particularly of longer maturities. Low and stable inflation since the mid-1990s has made it possible to extend India's sovereign yield curve. The RBI has also been actively engaged in developing the government securities market, inter alia, in terms of instruments and investor base, and the Bank has put in place an efficient infrastructure for trading, payment and settlement. These efforts have helped to contain the cost of government borrowing over the medium term. Therefore, a central bank that is also responsible for debt management can be equally committed to price stability, particularly when debt management is its statutory responsibility.

In this regard, Goodhart (2010) argues that debt management is again becoming a critical element in the overall conduct of macroeconomic policy. Hence, he suggests, central banks should be encouraged to revert to their role of managing the national debt. Subbarao (2011) also concludes that, on balance, and as long as there are institutionalised mechanisms to negotiate the various trade-offs within the overarching objective of achieving monetary and financial stability, the separation of debt management from central bank would seem to be a sub-optimal choice.

Further issues

The increased interaction between SDM and monetary policy raises two important issues that urgently need to be addressed: (i) to ensure seamless coordination between SDM and monetary policy, especially during turbulent times; and (ii) to revisit the role of central banks in public debt management. In countries where debt management has been separated from the central bank and entrusted to an independent debt management office (DMO), an institutional mechanism may exist for coordination between debt management and monetary policy. But the larger question is whether the desired coordination is taking place in practice, as the central bank and the DMO may at times find their objectives in conflict. Thus, the coordination mechanism needs to be reviewed, especially against the backdrop of auction failures in the United Kingdom and Germany in the recent past, and the sub-optimal debt structures implemented by some DMOs. In India, the 2007–08 budget announced that an independent DMO would be set up and a middle office has already been set up in the Ministry of Finance. If an independent DMO is established in countries where the responsibility for SDM currently lies with the central bank, then challenges might arise when seeking to ensure seamless coordination between monetary policy and debt management. This is particularly the case where the level of sovereign debt is high, as in India where government borrowing has increased in parallel with the fiscal deficit. A further challenge would be to ensure that the borrowing programmes of the central government and the sub-national governments are fully coordinated.

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