Dr. Reddy assesses the new directions being embarked upon in India with respect to the national budget and the Reserve Bank of India Address by the Deputy Governor of the Reserve Bank of India, Dr. Y. V. Reddy, at the Administrative Staff College in Hyderabad on 8/3/97.

1. It is a pleasure for me to be with you in the Administrative Staff College today. I have my gurus here, and I also have many friends. I spent a year on a full-time basis about a decade ago as Visiting Faculty here. I am thankful to the Principal for giving me an opportunity to speak on an important subject of contemporary relevance.

2. Mr.Chidambaram's budget of 1997 has been widely acclaimed as a trail-blazing breaking budget. From the point of view of Reserve Bank of India, it has very significant implications. The budget has acknowledged that interest tax is a bad tax and has commenced its phasing out. It has removed tax deduction at source on Government securities which was an irritant in developing an active secondary market for Government securities. The Government has accepted RBI's proposal to launch a capital indexed bond. In the external sector, the policy of capital outflows has been liberalised, acknowledging that globalisation is not a one-way street. Replacing the Foreign Exchange Regulation Act and designing a process of capital account convertibility are two of the announcements in the budget which are very dear subjects to me, but I will not comment on them. A Working Group and a Committee in the RBI are working on them and I cannot pre-empt their conclusions. There is, however, one subject which has generated debate, sometimes based on misinformation if not misunderstanding. That is the elimination of ad hoc Treasury bills Treasury bills and the introduction of a new system of Ways and Means Advances (WMA). My predecessor, Dr. S.S.Tarapore, who played a significant part in pursuing this idea, has described this change-over as a watershed in Indian monetary history.

The origin of ad hoc Treasury bills

3. The intellectual origins of ad hoc Treasury bills in their present form can be traced to the First Five Year Plan. It said, "Judicious credit creation somewhat in anticipation of the increase in production and availability of genuine savings has also a part to play". Thus, deficit financing, which in our context meant RBI credit to the Government, was assigned a place in the financing of the Plan though its volume was to be limited to the extent that it was non-inflationary.

4. The ad hoc Treasury bills thus emerged as a mode of financing the Central Government's deficit in the mid-1950s. For the smooth conduct of Government business, it was mutually agreed between the Central Government and the RBI that a minimum cash balance of Rs.50 crore on Fridays and Rs.4 crore on other days would be held by the Central Government. To adhere to this administrative arrangement, it was agreed that the Reserve Bank would replenish the Government's cash balances by the creation of ad hoc Treasury bills in favour of the Reserve Bank. The ad hoc Treasury bills, which were meant to be temporary, gained a permanent as well as a cumulative character. Indeed, it became an attractive source of financing Government expenditures since it was available at an interest rate pegged at 4.6 per cent per annum since 1974, i.e. actually at a negative real interest rate.

The assault on ad hoc Treasury bills

5. The Committee to Review the Working of the Monetary System recommended that the Reserve Bank adopt a system of monetary targeting with feedback. The target is to be

fixed taking into account the growth of the real sector and an acceptable order of increase in prices. The adherence to the target implied a limit to the monetisation of the Government's deficit. After all, any investment in Central Government securities by the RBI results in the monetisation of Government's deficit, as the RBI's credit to the Government is a source of reserve money generation.

6. Dr. Rangarajan, our Governor, brought out the ill-effects of the automatic monetisation of the Government deficit through ad hoc Treasury bills in his Presidential Address at the Annual Conference of the Indian Economic Association in December, 1988. He has been pursuing this subject with missionary zeal since then. Analysing fiscal and monetary interactions, he brought out the following issues.

First, the scale of Government borrowing was maintained at a high level and surpluses on revenue account have given way to deficits.

Second, such borrowing has been at less than market rates.

Third, even the growing captive investors in Government securities such as commercial banks were not willing to subscribe beyond their statutory obligations.

Fourth, the RBI as the manager of public debt became the residual subscriber.

Fifth, since the Government incurred deficits year after year, the question of the retirement of Treasury bills did not arise.

Sixth, the expansionary impact of these deficits, after taking into account the movements in net foreign exchange assets, had to be countered.

Seventh, to counter the impact, open market operations were not possible given the interest rate structure.

Eighth, this meant that the cash reserve ratio had to be increased to absorb the excess liquidity.

Finally, when ad hoc Treasury bills were created automatically to finance the Central Government's deficit without any limit, the system contributed to rapid monetary expansion when the budget deficit became very large.

Dr.Rangarajan concluded his analysis with a solution, i.e. an agreement between the Government and the Reserve Bank of India setting a limit each year on the size of the fiscal deficit and its monetisation. This agreement would provide greater manoeuvrability to the RBI to regulate the volume of money. Monetary targeting would then be meaningful. What we have arrived at today in the budget of 1997 is exactly what was envisaged in 1988.

The process of elimination

7. The process of the elimination of ad hoc Treasury bills has been designed in three stages :

First, through limits on the creation of ad hoc Treasury bills which operated between 1994-95 and 1996-97.

Second, through a transition period of two years beginning April 1, 1997, when ad hoc Treasury bills are eliminated and the new system of Ways and Means Advances is introduced; but, overdrafts above Ways and Means would be permissible beyond ten continuous working days, though at a cost.

Third, the full-fledged system of Ways and Means Advances operates effective April 1999.

We have completed the first phase, agreed on the second and third phases and are commencing the transition period, viz., the second phase from April 1997. The second and third phases would become operational through a fresh agreement between the Government of India and the Reserve Bank of India. Incidentally, the arrangements for WMA to state governments are also based on agreements between the Reserve Bank of India with state Governments.

The experience with the first phase

8. In September 1994, it was mutually agreed between the Government and the RBI that limits will be placed on the net issue of ad hoc Treasury bills for year-end and also within the year. The year-end limits of Rs.6,000 crore for 1994-95 and Rs.5,000 crore for the next two years were fixed. The within-the-year limit during this period was kept at Rs.9,000 crore.

During 1994-95, the net issue of ad hoc Treasury bills during the greatest part of the year was negative and even at the end of the year the net issue was only Rs.1,750 crore, much lower than the year-end cap. During the years 1995-96 and 1996-97, though, there was some difficulty in staying below the within-the-year limits; it may be noted that during 1996-97, since August 14, 1996, net issues of ad hoc Treasury bills remained mostly below the within-the-year limit. The most significant part of this agreement was that the practice of issuing ad hoc Treasury bills to finance the Central Government's deficit would be totally discontinued by 1997-98. In last year's budget, the Government committed itself to announcing concrete proposals for phasing out ad hoc Treasury bills. This year, the Finance Minister did exactly what he promised - to comply with the agreement.

9. A question that is often asked is what happens to the ad hoc Treasury bills outstanding? The outstanding level of ad hoc Treasury bills as at end-March 1997 will have to be funded into special securities at an interest rate of 4.6 per cent per annum. These securities, in addition to the volume of funded securities of Rs.71,000 crore already in the books of the RBI, will continue to be held by the Reserve Bank. The Reserve Bank at a later stage may have to use these securities for open market operations by converting them into marketable lots.

The New System

10. What will the proposed system be like?

First, a scheme of WMA by the Reserve Bank of India to Government of India (GOI) has been evolved to accommodate temporary mismatches in Government receipts and payments.

Second, the limit for WMA and the rate of interest on WMA will be mutually agreed between the RBI and the Government from time to time.

Third, any withdrawals by the Government from the Reserve Bank of India in excess of the limit of WMA would be permissible only for ten consecutive working days.

Fourth, when 75 per cent of WMA is utilised, the Reserve Bank would trigger a fresh floatation of Government securities.

Fifth, consistent with the discontinuance of ad hoc Treasury bills, the system of 91 days tap Treasury bills will also be discontinued with effect from April 1, 1997.

Sixth, with the discontinuance of ad hoc Treasury bills and tap Treasury bills and the introduction of WMA, the concept of the conventional budget deficit loses its relevance. Therefore, it is proposed to discontinue the practice of showing the budgetary deficit; instead the gross fiscal deficit would become the key indicator of the deficit. As a transparent way of reporting the monetised deficit, or net RBI Credit to the central Government, the likely extent of RBI support in respect of dated securities and auction Treasury bills is shown separately as the 'monetised deficit' in the budget document.

Ad hoc Treasury bills and WMA: differences

11. There are significant differences between ad hoc Treasury bills and WMA.

First, WMA will not be a source of financing the budget deficit. It is only a mechanism to cover day-to-day mismatches in receipts and payments of the Government. Therefore, the use of WMA will have to be periodically suspended. WMA will also not be shown as a source of financing in the budget estimates.

Secondly, limits on WMA will be fixed and any excess withdrawal by the Government beyond the limit will become permissible for no more than 10 consecutive working days.

Thirdly, WMA will be charged at a market related interest rate.

The transition period

12. It is possible to argue that the period of agreement between 1994-97 itself was a transition and a further transition now is not necessary. However, the introduction of a fundamental change in a public system requires that functionaries in a variety of organisations in Government change procedures and cash management practices. This simply cannot happen like a dress rehearsal before the new system. In fact, some minor modifications may be needed as we go along. To say that transition is meant to dilute implies a predisposition to suspect the motives. After all, the change-over from the old system to new system should be smooth. The Government should evolve expenditure control mechanisms and improve its day-to-day cash management. It may be necessary for the Government to discuss with major ministries for this purpose. The Reserve Bank would also attempt to streamline its debt management techniques. The RBI will make efforts to develop the Treasury bills market by proactive participation and issuing of Treasury bills of different maturities. Therefore, a transition period of two years has been proposed. During the transition period, the Government would be allowed to exceed the limit of WMA for periods beyond 10 consecutive working days. But, additional interest will be applied for such periods on the amount of overdraft.

The current debate

13. Following the announcement of the new system and the presentation of the budget incorporating the new system there has been a debate on the features of the system as well as its functioning in 1997-98.

First, that it is only a new name for the old system.

Second, that without a statutory ceiling on debt, the system will serve no purpose.

Third, that the degree of autonomy for monetary policy is still limited.

Fourth, that the budgeted figures show that the new system will involve large borrowings and more monetisation and, therefore, is inflationary. Let me analyse each one of the issues.

14. As already explained, the new system implies the repayment of advances made and not their accumulation year after year. The limits are fixed and exceeding the limits is simply not permitted beyond ten days once the system becomes fully functional. There is a cost of using such advances which is market-related. In addition, there is also the important advantage of providing mechanisms for open market operations to take care of surges in inflows of foreign capital. This is difficult under a system of ad hoc Treasury bills but is possible when auction Treasury bills and dated securities take the place of ad hoc Treasury bills. Market-based instruments are absolutely essential as we move along the path of capital account liberalisation. Further, the system is far more binding and transparent since the level of borrowings and the pattern of financing, especially RBI's contribution, are made part of budget documents. Finally, the mixed bag that budget deficit represents is replaced by a more transparent method.

15. Perhaps it is necessary to clarify the three concepts viz. the budget deficit, the monetised deficit or the net RBI credit to the Government and the RBI's support in primary issues of central Government securities. The budget deficit is defined as the total of the net issue of 91-day Treasury bills (at face value) - ad hoc Treasury bills Treasury bills, tap and auction - net of increases in central Government balances during the financial year. Therefore, conceptually, the budget deficit is the short-term financing availed of by the central Government both from the Reserve Bank and other entities which include banks, financial institutions, state Governments, corporates and other parties. In this set-up, the Reserve Bank is only one of the financing units of the budget deficit.

Net reserve bank credit to the central Government, on the other hand, includes not only the Reserve Bank's holdings of 91-day Treasury bills but also its holdings of dated securities and rupee coins net of the increase in the central Government's cash balances. In other words, the Reserve Bank's holdings of 91-day Treasury bills that forms a part of budget deficit is also a subset of the monetised deficit. However, it may be noted that while the constituents of the budget deficit are measured at face value, those of the net Reserve Bank credit to the central Government are measured at book value. This valuation difference is, however, negligible particularly for 91-day Treasury bills.

The correlation between the budget deficit and the monetised deficit grows weaker at times of easy liquidity such as during the current financial year as absorption by the market of Government securities including 91-day Treasury bills has gone up substantially. The purchase of Government securities by non-RBI entities reduces the monetised deficit in two ways : (i) directly by reducing the devolvement on the Reserve Bank of 91-day Treasury bills and dated securities auctions as well as through the sale of dated securities including repos and

ii) indirectly, as the market off-take of tap Treasury bills and fresh Government securities improves the central Government's cash balances and reduces the central Government's recourse to ad hoc Treasury bills.

16. The RBI's support to primary issues of central Government securities reflects only its support in the primary offers, and net RBI credit to the Government could be very different due to other factors. Let me illustrate this with some figures. In 1993-94, the RBI's support to Government was Rs.7,014 crore, but net RBI credit was only Rs.260 crores. In 1996-97, till February 14th, RBI's support was Rs.12,099 crore, but, net RBI credit was only Rs.7,837 crore. The monetised deficit is one source of the money supply and is not the only factor affecting the money supply.

17. It is sometimes argued that the real instrument for fiscal prudence should be a statutory ceiling on debt. True, our constitution enables Parliamentary legislation relating to a ceiling on debt. The Ministry of Finance is due to bring out a Discussion Paper on this. Let me not pre-empt its content. But, clearly the new system has merits of its own and will co-exist more effectively with a ceiling on debt. It has merits in itself since it seeks to limit the extent of the RBI's support. Technically, there is nothing to stop the Government from accessing all the debt within the ceiling from the RBI if the new system did not exist. A ceiling on debt provides a constraint on the broader issue of debt management and impinges on fiscal policy more directly. The new system tackles the issue of fiscal/monetary interface which is a critical component of both fiscal and monetary policies.

18. It is sometimes argued that the degree of autonomy for monetary policy is still limited. To the extent the limits on WMA interest costs and the RBI's support to the Government are negotiable during the transition, there is room for the Government to influence the RBI. The main difference is that under the earlier system of automatic monetisation the Government could unilaterally determine the limits, while after the new system becomes fully functional, the pattern similar to state Governments would be followed. The data in the budget for 1997-98 are quoted to show that the RBI has not gained in autonomy. That leads me to an analysis of these figures and the inflationary potential of the borrowing programme and the pattern of financing.

19. In the current debate, some have presumed that as per budget estimates, the increase in high-powered money for 1997-98 would consist of Rs. 16,000 crore (the monetised deficit) plus Rs.7,000 crore on account of the increase in the average level of WMA. This presumption is wrong for two reasons:

First, the budget estimates for monetised deficit at Rs.16,000 crore would consist of the increase in RBI's holdings of Government securities including dated Government securities and the RBI's holdings of auctioned Treasury bills.

Second, the budget estimates for 1997-98 have not assumed any contribution to the budget from WMA. It may be mentioned that Rs.100,000 crore has been shown on both the receipts side and the disbursements side, implying that whatever WMA were taken by the Government would be repaid before the end of the year.

20. Some others have argued that there is a large increase in net borrowings of Government, of the order of 33 per cent, negating the intentions of the new system. Here again, the comparison between the net market borrowing figures of Rs.25,498 crore for 1996-97 and Rs.33,820 crore for 1997-98 is misleading. The figure for 1996-97 excludes financing through

the budget deficit i.e., mainly through the instrument of 91-day Treasury bills including ad hoc Treasury bills. The figures of 1997-98 under market borrowings would include borrowings through 91-day (auction) Treasury bills. Therefore, the comparable figures would be Rs.32,398 crore for 1996-97 [(Rs.25,498 crore of net market borrowing plus Rs.6,900 crore of the budget deficit (RE)] and Rs.33,820 crore for 1997-98 (total net market borrowing), implying an increase of only 4.4 per cent.

21. Some others have argued that, at 16 per cent, the growth in the money supply would imply an inflation of 10 per cent if GDP grows at 6 per cent. The money supply growth indicated here is in terms of broad money and not narrow money. The income elasticity of demand for broad money which has been proven to be reasonably stable and is in the range of 1.5 to 1.6 in India should be taken into account. Even accepting that growth in GDP will be no more than 6 per cent, the implied inflation could be only between 7.0 per cent (16.0 - 9.0) and 6.4 per cent (16.0 - 9.6).

Outlook

22. Let me conclude with the outlook for the successful implementation of the new system.

First, let us recognise that what we are doing is really adhering to what the First Five Year Plan visualised, viz. judicious credit creation.

Second, we are trying to operationalise the monetary targeting that Prof. Sukhamoy Chakravarthy's Committee wanted us to. No doubt, we have to move to indirect instruments of monetary policy, but we cannot escape some sort of effective monetary targeting.

Third, a process of thinking initiated by Dr. Rangarajan in 1988, further elaborated by him into a proposal in the Kutty Memorial Lecture on “Autonomy of Central Banks” in September 1993, and formalised through an agreement between him as Governor and Prof. Manmohan Singh as Finance Minister has been honoured by our present Finance Minister Shri P. Chidambaram. We therefore have reason to believe that there is a consensus on the new system.

Fourthly, the critics have not questioned the need for closer fiscal monetary interaction or a more autonomous monetary policy. If at all, the critics want to make sure that the new system works effectively towards its objectives.

Finally, what has been put in place is a system and undoubtedly a better system than ad hoc Treasury bills and is certainly more suited to our times as well as our policies in the external sector. How it operates depends on public opinion, economic compulsions and the good faith with which this is implemented by the Government and the Reserve Bank of India.