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ROUND TABLE

Separation of debt and monetary management in India☆

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Debt management office (DMO);
Independence of a central bank;
Independent debt management office

Abstract The discussion highlights the importance of and the need for a separate debt management office, separate from the monetary authority. The objective of debt management is raising resources from the market at minimum cost while containing the risks, while that of the monetary authority is to achieve price stability. In the years preceding the financial crisis of 2008, separation of debt and monetary management was a settled norm and a number of countries with liberalized financial markets and high levels of government debt sought to adopt professional debt management techniques to save cost and to provide policy signals to the market. Separation of debt management is essential to preserve the integrity and independence of the central bank, to ensure transparency and accountability, and to improve debt management by entrusting it to portfolio managers with expertise in modern risk management techniques. In India, debt is managed by the central and state governments, and the RBI. The separation of debt management would provide focus to the task of asset-liability management of government liabilities, undertake risk analysis and also help the government to prioritize public expenditure through higher awareness of interest costs. The separation would also be helpful for the borrowing programme which would have to be completed without the support of the regulatory or supervisory authority. This may lead to widening of investor base and market friendly yield curve.

But after the great financial recession of 2008, the issue has re-emerged as in many countries, especially the advanced economies, the scope of fiscal operations was expanded, and the debt to GDP ratios have increased substantially. Similarly, in view of the sensitiveness of the issue, especially amidst less developed financial markets, there has been some re-thinking on the issue; in India, the Reserve Bank has also been re-thinking the separation issue and seems reluctant given the present context of the economy.

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Introduction

In recent years, after the global crisis (2008), the issue of separation of monetary management from fiscal and debt management operations has re-emerged. In many countries, during the period of crisis, the scope of fiscal operations was expanded; the debt to GDP ratios also increased significantly. Consequently debt management encountered difficulties, and coordination between monetary management and debt management assumed greater significance.

Historically, the debt crises of 1982 and the East Asian financial crisis of 1997 led many countries to assign priority to public debt management and several countries chose to separate debt management from monetary management. As government securities markets became mature and more sophisticated, a separate institutional structure was considered to be better suited to achieve an appropriate balance between monetary policy and debt management objectives. In normal economic circumstances the central bank operates at the short end of the market and debt management at the long end to minimize cost of raising resources but in times of crisis, the operations can become blurred. A separation in responsibilities was considered a better solution that would reduce the risk of policy conflicts. Once the financial markets had developed, the role of the central bank in sustaining the stability of markets was considered minimal. Therefore, in many of the Organisation for Economic Co-operation and Development OECD countries, separation of debt management and monetary management was undertaken in the 1990s.

The round table discussion follows a brief contextual introduction to the issue, covering the objectives of debt management; traditional and post-crisis viewpoints about separation of debt management; central banks' independence; coordination between debt management, monetary and fiscal operations; debt management practice in India; and the role of the Reserve Bank of India (RBI).

Objectives of debt management

The main objective of debt management is to minimize the cost of borrowings over the medium to long run, consistent with a prudent degree of risk. To achieve this, promotion and development of efficient primary and secondary markets for government securities is an important complementary objective. Hence, public debt management can be explained as the process of executing a strategy for managing the government's debt — to raise the required amount of borrowings, pursue cost/risk objectives, and also meet any other goal that the government might have set (IMF, 2003). This assumes added significance with high fiscal deficits and government debt.

Separate debt management office — a traditional view

There was a growing consensus among practitioners until 2008 to treat debt management as a separate policy instrument from monetary policy. A number of countries with liberalized financial markets and high levels of government debt sought to adopt professional debt management techniques to save cost and to provide policy signals to the market (Giovannini, 1997). The benefits of separation of the two functions were basically conditional upon the level of financial development as argued by Blommestein and Turner (2012). The trend started with New Zealand in the 1980s, with the government recognizing the need for proper policy assignment and an accountability framework for debt management to meet the fiscal targets set in the Fiscal Responsibility Act. In Europe, several countries that were heavily indebted in the late 1980s and early 1990s, such as Belgium, France, Ireland and Portugal, decentralized debt management to varying extents, in order to reduce the variability of debt service cost that could jeopardize the targets set by the Growth and Stabilization Pact. In the UK, debt management responsibilities were taken away from the Bank of England in order to remove the perception of conflict of interest in conducting debt management and monetary operations (Togo, 2007).

A number of countries have chosen to open a separate debt management office to have a more focussed debt management policy in terms of cost of borrowings, market determined yield curve, and optimal mix of maturity profile of outstanding loans (Table 1). The location of the debt management office is important and depends on a number of considerations. The dispersal of debt management functions within different layers of government can lead to lack of coherent debt management policy and overall risk assessment, and therefore higher operational risk.[1] Some OECD countries have opted for an autonomous debt management office to improve operational efficiency while others, seeking a balance between public policy and financial management, have a separate office but operating under the Ministry of Finance (MOF). In Denmark, debt management is undertaken by a privately owned central bank (OECD, 2002). In the case of developing countries, Currie, Dethier and Togo (2003) argue that the separate office can be initially placed under the MOF while Kalderen (1997) suggests that a separate office may be unsuitable for overall policy effectiveness of debt management.

On the basis of the experience of OECD countries, Cassard and Folkerts-Landau (1997) concluded that several reasons emerge that justify the separation of debt management — to preserve the integrity and independence of the central bank, to shield debt management from political interference, to ensure transparency and accountability, and to improve debt management by entrusting it to portfolio managers with expertise in modern risk management techniques. The separation of debt management and monetary management positively affects expectations as it explicitly indicates to the market that monetary policy is independent of debt management.[2]

The classic conflict between monetary policy and debt management policy, and operations relates to the fixation of interest rates. The interest rates on government securities are crucial in determining the yield curve and prices

[1] Operational risk, generally neglected in debt management, pertains to internal processes, people and systems.

[2] In case the two are not separated, then debt management policy eventually becomes subservient to the monetary policy as the monetary authorities attempt to use debt instruments to strengthen monetary policy signals and to enhance the credibility of the central bank.

Table 1 Location of debt management office in select countries.

Country	Location of debt management office	Scope of debt management			Advisory board
		Cash	Debt	Contingent	
1. Australia	Separate agency under Treasury since 1999	Yes	Yes	No	Yes
2. Brazil	Debt office under Treasury since 1988	Yes	Yes	No	No
3. Colombia	Debt office under Treasury since 1991	No	Yes	Yes	Yes
4. Denmark	Debt office in central bank	Yes	Yes	Yes	No
5. France	Separate agency under Treasury since 2001	Yes	Yes	No	Yes
6. Germany	Separate agency under Treasury since 2001	Yes	Yes	No	No
7. Ireland	Separate agency under Treasury since 1991	Yes	Yes	No	Yes
8. Italy	Debt agency under Treasury — 1997	Yes	Yes	No	No
9. Mexico	Separate office in Treasury	No	Yes	Yes	No
10. New Zealand	Separate office under Treasury since 1988	Yes	Yes	Yes	Yes
11. Poland	Debt office within Treasury since 1994	No	Yes	Yes	No
12. Portugal	Separate debt office under Treasury since 1996	Yes	Yes	Yes	Yes
13. Sweden	Separate debt office under Treasury since 1789	No	Yes	Yes	Yes
14. UK	Separate debt office under Treasury since 1997	Yes	Yes	No	Yes
15. USA	Debt office within Treasury	Yes	Yes	No	No
16. South Africa	Debt Management Office within Treasury	Yes	Yes	Yes	No

Source: Singh (2005).

of financial assets in the economy. The conflict of debt management with monetary management arises due to the choice of keeping debt servicing costs low over the short term or over the medium-long term. A separation of these two was expected to avoid such conflicts and improve policy credibility.

In case the central bank conducts debt management policy, conflicting situations may emerge. Questions arise such as whether liquidity should be tightened based on monetary conditions prevailing in the economy or relaxed to ensure success of market borrowing programme of the government? Another area of concern could be interest rates which are of prime importance to the central bank and serve as a benchmark in transmission mechanism through the yield curve. The government would like to borrow at low costs while the central bank might consider monetary tightening in the context of financial stability more important. Further, the central bank may be tempted to manipulate financial markets to reduce the interest rates at which government debt is issued (Cassard & Folkerts-Landau, 1997). In the case of developing countries, where financial markets are generally underdeveloped there is yet another concern and that is the limited financing options of the government and uncertain cash requirements that constrain independence of the central bank. Taylor (1998) argues that the accord between the Federal Reserve (Fed) and the Treasury in 1951 in the US, which emancipated the Fed from assisting the Treasury in borrowings at low rates of interest, helped the Fed to focus on interest rates. Even if a separate department within the central bank conducts debt management, the market will still perceive that the debt management decisions are influenced by inside information on interest rates policy. In contrast, a statutory and separate authority for debt management could facilitate direct reporting to the parliament which will prompt better fiscal discipline, appropriate audit, and financial and management controls.

Central bank independence

The other factor supporting separation of debt from monetary management was the argument in favour of independence of the central bank. In the years until 2008, because of the great moderation and Volcker's victory over inflation[3] in the 1980s, substantial evidence had been advanced in theoretical and empirical literature to support the political and economic independence of the central bank (Grilli, Masciandaro & Tabellini, 1991a). In support of central bank independence, Kydland and Prescott (1977), Barro and Gordon (1983a and 1983b), Burdekin and Laney (1988), Eschweiler and Bordo (1993) and Grilli, Masciandaro, and Tabellini (1991b) argue that more independent central banks reduce the rate of inflation, while Alesina and Summers (1993) conclude that such independence has no impact on real economic performance. Wagner (1998) argues that making a central bank independent lowers "expectations" pertaining to inflation of the private sector that determine wage and price contracts, and thereby also the expectations that impact exchange rates.

Separate debt management office — post-crisis view

Following the financial crisis of 2008, there has been a rethink on the issue of separation of debt management from monetary management because of the following factors a) a sharp increase in government deficit and debt, because of the fiscal stimulus; b) the use of unconventional

[3] http://www.carnegie-rochester.rochester.edu/nov04-pdfs/gk.pdf.

monetary policy in advanced countries involving large scale purchase of government securities of varying maturities; c) imposition of new liquidity requirements resulting in higher demand for government securities; and d) increase in foreign ownership of government debt.

Thus, the thrust of the recent debate is that under a difficult macroeconomic situation, the lines between debt and monetary policy become blurred and hence the two functions should be brought under the same agency. In the UK, there is a discussion on this but not in the US where the two functions were separated in 1951. Goodhart (2012) argues that under quantitative easing there is a possibility that the policy of debt management, if separate, can negate the policy of the central bank, and separation between debt management and monetary policy is not desired as the existing arrangements are already under stress. On the other hand, the Study Group (SG) commissioned by the Committee on the Global Financial System (2011), observed that there was little evidence that existing arrangements for operational independence of sovereign debt management and monetary policy have created material problems.

Need for coordination

In each country, the economic situation, including the state of domestic financial markets and the degree of central bank independence, would play an important role in determining the range of activities to be handled by the debt manager and the level of coordination that is necessary with monetary management. Monetary policy and debt management clearly have to be complementary to each other but debt management should not be considered a tool of monetary management nor should monetary policy be considered the objective of debt management (Bank of England, 1995). In the case of the Economic and Monetary Union (EMU), monetary policy is operated by the European Central Bank (ECB) while national authorities conduct debt management. The sharing of adequate information between treasuries, national central banks and the ECB is a norm, and ensures efficient liquidity management.

In the case of developing countries, coordination between fiscal, monetary, and debt management functions is considered even more crucial, where financial markets are under-developed and forecasts of government revenues and expenditure are inaccurate. The issuance of government securities by a separate debt office needs to be closely coordinated with the open market operations undertaken by the central bank to ensure appropriate liquidity conditions in the market.

Therefore, the role of the central bank in public debt management, though separated, would continue to be crucial. As an issuing agency of government securities, the central bank organizes rules and procedures for selling and delivering securities and for collecting payments for the government. As a fiscal agent, the central bank makes and receives payments, including interest payments and servicing of principal. As adviser to the government and to the debt manager, it could provide policy inputs on the design of the debt programme, mix of debt instruments and maturity profile of debt stock. These inputs would be useful in providing stability to the overall debt programme, facilitating smooth functioning of the market, and providing a stable environment for the conduct of monetary policy.

Recent experience shows that there is a need for close communication and coordination among the relevant agencies managing monetary policy and debt management, as stressed by the Study Group commissioned by the Committee on the Global Financial System (2011), and as is consistent with the Stockholm Principles (2011).[4]

Another important change is concurrently occurring in the monetary policy objectives internationally. While theoretical arguments can be made to justify recent departures from policy, the reality is that in the post-crisis world, objectives of the central bank are no longer limited to price stability. A dilution of central bank independence has occurred because of the multiple objectives such as pursuit of GDP growth, job creation, and financial stability. The need to establish priorities when there are trade-offs clearly requires political decisions which cannot be made by unelected officials alone. Moreover, by pushing interest rates toward zero, the current policy of quantitative easing has strong, often regressive income effects which cannot be implemented without political patronage. Hence the emerging consensus in the post-crisis period is that central banks' decision-making should be subject to political control (Blejer, 2013).

Debt management in India

In India, presently, public debt management is divided between the central and state governments, and the RBI. The RBI manages the market borrowing programme of the central and state governments.[5] External debt is managed directly by the central government. The RBI acts as the debt manager for marketable internal debt for the central government as an obligation and for the state governments by an agreement under the RBI Act, 1934. The RBI decides the maturity pattern, calendar of borrowings, instrument design and other related issues in consultation with the central government (IMF, 2003).[6]

The most important component of domestic debt is internal debt (Table 2). The Constitution of India provides for the option of placing a limit on the internal debt, both at the centre and the states, but no such limit has been imposed so far. Internal debt, the most prominent component of domestic debt, consists of markets loans, treasury bills and other bonds issued by the central and state governments or all types of borrowings by the government. In addition to internal debt, the government also raises resources through small savings and contributions to provident funds. Loans from banking and financial institutions are mainly raised by the state government. Governments also raise resources termed as reserve funds and deposits, which need to be managed.

[4] Stockholm Principles (2011) were promulgated by debt managers and central bankers from 33 advanced and emerging market economies.
[5] Exceptions are Jammu and Kashmir, and Sikkim.
[6] Thorat, Singh and Das (2003).

Table 2 Components of domestic debt of the government (As percent to the total).

Year	Internal debt	Small savings deposits and provident funds	Reserve funds and deposits and other accounts	Domestic debt
1980–81	60.6	22.6	16.8	100.0
1990–91	51.3	23.3	25.4	100.0
2000–01	67.4	13.0	19.6	100.0
2010–11	70.7	16.6	12.7	100.0
2011–12	73.5	15.2	11.2	100.0
2012–13	75.9	14.1	10.0	100.0

Source: RBI.

Since the beginning of planning in India in 1951, the amount of market loans mobilized annually has been rising rapidly. While formulating the borrowing programme for the year, the government and the RBI take into account a number of considerations such as the central and state loans maturing for redemption during the year, an estimate of available resources, and absorptive capacity of the market. The government also offers a variety of small savings schemes to meet the varying needs of different groups of small investors. Statutory rules are framed by the central government indicating various details including the rate of interest and the maturity period, with respect to each scheme. There is however, a lack of comprehensive analysis of the liabilities of the central and state governments and their distributional aspects, which impedes informed decision regarding domestic borrowing.

Role of the RBI

The key role in management of internal debt is played by the RBI which could conflict with its pursuit of the objectives of monetary policy. The RBI is the regulator and supervisor of the financial system, including banks, and also of the money, government securities, and foreign exchange markets. The RBI has to balance the needs of the markets (manage liquidity), government requirements (short and long term fiscal requirements), balance sheet of the banks (asset prices and interest rate movements) and general price level (growth of money supply).

In the RBI, the Internal Debt Management Department (IDMD), set up in April 1992, undertakes the function relating to issuance of government securities, treasury bills including cash management bills and cash management of both central and state governments. The RBI as a regulator and supervisor of the banking sector is able to ensure, sometimes through moral suasion, that the borrowing programme of the government is completed. The IDMD is organized essentially as a separate debt management office with the essential units — primary market (borrowing and cash management of both central and state governments), policy and research, dealing room, management information system and regulation (primary dealers). The actual receipts of bids and settlement functions are undertaken at various offices of the RBI especially public debt offices (PDOs) located across the country. The PDOs of the RBI also manage registry and depository functions, including the book entry form of ownership. The Department of Government and Bank Accounts (DGBA) maintains the accounts of both the central and state governments. On external debt, the Department of External Investment and Operations (DEIO) in the RBI works as a front office along with the MOF. The function of cash management of the central and state governments is also performed by IDMD in coordination with DGBA in the RBI. The managerial structure of public debt management is presented in Table 3. On the issue of other components of internal debt, the government has a different role. The government announces the interest rate of various financial instruments like small savings and provident funds. External debt is managed by the government of India (GOI) in consultation with the RBI. Interest rates on reserve funds and deposits are again fixed differently by different governments.

Coordination between RBI, government and markets

There are various committees in the RBI that coordinate the activities of debt management with the fiscal authorities. The Cash and Debt Management Committee, consisting of officials from the MOF and the RBI meets regularly to discuss the operational details of market borrowings for the central government. The issues pertaining to the state governments are discussed in a semi-annual meeting with the officials from MOF, DOF and RBI. The Technical Committee on Money and Government Securities, consisting of representatives from the market, academia, the government, banks, and the RBI meet regularly and advise the RBI on development and regulation of the government securities market.

Need for separation of debt management and monetary management

In India, separation of debt management would provide the RBI with the necessary independence in monetary management and create an appropriate environment to pursue an inflation target, if assigned by the government. The separation of debt management would provide focus to the task of asset-liability management of government liabilities, undertake risk analysis and also help the government to prioritize public expenditure through higher awareness of interest costs. The separation would also imply that the borrowing programme would have to be completed without any support of the regulatory or supervisory authority, and widening of the investor base. This implicitly would lead to

Table 3 Management of public debt in India.

Major items	Appropriated by	Managed by	Fixation authority for/determination of		
			Amount	Maturity	Interest rate
1	2	3	4	5	6
Market loans	Centre	MOF, RBI	MOF	MOF, RBI	Market
	State	DOF, RBI	MOF	DOF, RBI	RBI, Market
Market bonds	Centre	RM, MOF, RBI	RM, MOF	RM	RM, MOF, RBI
	State	RD, DOF, RBI	RD, DOF	RD	RD
Treasury bills	Centre	MOF, RBI	MOF, RBI	MOF, RBI	Market
WMA	Centre	MOF, RBI	MOF, RBI	MOF, RBI	RBI
	State	DOF, RBI	RBI	RBI	RBI
Loans from Bk & FI	State	DOF	RD	RD	RD, DOF
Small savings	State	MOF, DOF	MOF, DOF	MOF	MOF
Provident funds	Centre	MOL, MOF	MOL, MOF	MOL	MOL
	State	MOL, DOF	DOF	MOL	MOL
Reserve funds/Deposits	Centre	RM, MOF	RM	RM	RM
	State	RD, DOF	RD	RD	RD
External debt	Centre	MOF, RBI	MOF	MOF	MOF
Contingent liabilities	Centre	RM, MOF	RM	RM	RM
	State	RD, DOF	RD	RD	RD

MOF — Ministry of Finance; DOF — Department of Finance; MOL — Ministry of Labour; RM — Respective ministry; RD — Respective department; Bk — Banks; FI — Financial institutions; WMA — Ways and Means advances.
Source: Author's compilation.

a more representative market-determined yield curve reflecting term structure and liquidity of the outstanding portfolio. The need for setting up a specialized framework on public debt management which will take a comprehensive view of the liabilities of the government and establish the strategy for low-cost financing in the long run has been advocated by various expert committees since the late 1990s (Table 4).

In India, a watershed moment in the institutional arrangements of debt management was the setting up of the middle office in the Ministry of Finance in 2008 to formulate debt management strategy for the central government. Again, the Union Budget 2011—12 stated that the government was in the process of setting up an independent Debt Management Office (DMO) in the Ministry of Finance. Similarly, the Union Budget for 2012—13 proposed to move the Public Debt Management Agency Bill in parliament.

However, an important re-think in the whole process was required because the RBI was not convinced that the separation would be useful for the financial markets (Khan, 2014). Despite consistency in recommendations of separating debt management from monetary management, there has been hesitancy on part of the RBI and GOI, as documented in speeches by the top management and arguments offered in the annual reports of the RBI. The main arguments advanced are that there already is a separate department within the RBI and that during these critical economic years, need for coordination would be immense and that the government may not have the necessary experience or expertise.

Separation of debt and monetary management in India: A panel discussion[7]

Anchor
Charan Singh
Panelists
Harun R Khan
Deputy Governor, Reserve Bank of India
K Kanagasabapathy
Former Director, EPW Research Foundation
R K Patnaik
Professor, SP Jain Institute of Management and Research, Mumbai
Vijay Singh Chauhan
Director, Ministry of Finance, Government of India
Peeyush Kumar
Director, Ministry of Finance, Budget
Ritvik Pandey
Indian Administrative Service
Benno Ferrarini
Senior Economist, Asian Development Bank

Charan Singh (CS): *The central bank's effective autonomy remains somewhat ambiguous till date; hence, it is possible that the Reserve Bank of India may become vulnerable to the populist policy measures of the central government? In that case, meeting policy objectives including debt management will be practically difficult. Under such circumstances don't you think a separate Debt Management Office (DMO) with autonomous powers would serve the purpose more effectively?*

[7] The Round Table Discussion on Debt Management was held at IIM Bangalore in August 2014. The views of the panellists are strictly personal and academic in nature. The views expressed by the panellists should not be construed as those of the affiliated institutions of the respective panellists as these were in pursuance of academic arguments in an academic institution.

Table 4 Timeline: separation of debt management.

Year	Source	Recommendations
1997	Report of the Committee on Capital Account Convertibility (Chairman: Dr. S.S. Tarapore)	Setting up of an Office of the Public Debt (OPD)
1997	A Working Group on Separation of Debt Management from Monetary Management (Chairman: M. Narasimham)	Separate Debt Management Office (DMO) as a company under the Indian Companies Act
2000	The Advisory Group on Transparency in Monetary and Financial Policies	Independent DMO, in a phased manner
2001	The RBI Annual Report 2000—01	Separate DMO
2001	The Internal Expert Group on the Need for a Middle Office for Public Debt Management, (Chairman: A. Virmani)	Establishing an autonomous Public Debt Office
2003	The Fiscal Responsibility and Budget Management (FRBM) Act	Prohibits the Reserve Bank from participating in the primary market for central government securities with effect from April 2006
2004	The Report on the Ministry of Finance for 21st Century (Chairman: Vijay Kelkar)	National Treasury Management Agency
2006	Fuller Capital Account Convertibility (Chairman: S.S. Tarapore)	Set up of Office of Public Debt outside RBI
2007	The Union Budget 2007—08	Establishment of a DMO in the government.
2008	The High Level Committee on Financial Sector Reforms (Chairman: Raghuram Rajan)	Structural change of public debt management, such that it minimises financial repression and generates a vibrant bond market. Set up independent DMO
2008	Internal Working Group on Debt Management (Chairman: Jahangir Aziz)	Establishing a DMO
2009	Committee on Financial Sector Assessment (Chairman: Rakesh Mohan)	Setting up DMO
2012	Report of the Working Group on Debt Management Office (Chairman: Govinda Rao)	Independent DMO
2012	The Financial Sector Legislative Reforms Commission Approach Paper	Separation of debt management with specialized investment banking capability for public debt management
2013	The Financial Sector Legislative Reforms Commission (Chairman: B.N. Srikrishna)	Specialized framework to analyse comprehensive structure of liabilities of the government, and strategizing minimal cost techniques for raising and servicing public debt over the long term within an acceptable level of risk

Source: Various Reports, GOI and RBI.

Harun Khan: The public discourse has focussed on three kinds of conflict in sovereign debt management being done by the central bank: a) The objective of the RBI as a public debt manager may conflict with the prevailing monetary policy stance and the market participants; the central bank may not be increasing interest rates to keep borrowing costs low and thereby compromising on inflation management; b) The central bank, being also a debt manager, could take government debt on its balance sheet to ensure successful government borrowing implying that the government borrowing plan is completed without any shortage of resources to the government; and c) The imperatives of the government borrowing programme may influence the decision of the RBI as regulator of banks, to reduce the Statutory Liquidity ratio (SLR) requirements. In my view, the institutional arrangements for debt management must take into account the country specific context and requirements. To set the context for this debate, we can examine the conflict of interest argument in the Indian context. Even as the government's borrowings went up both in absolute and proportional terms, the RBI raised policy rates several times during the past five years; clearly indicating its commitment to price stability. The FRBM Act, 2003 which precluded the RBI from participating in the primary auction of government bonds has resolved the conflict of interest with monetary policy. Monetary signalling in India is now done by the repo rate (policy rate) under the liquidity adjustment facility (LAF) and not the bond yields. While theoretical formulations can conjecture conflicts of interest, the validity of assumptions need to be tested by evaluation of experience/performance and on that count, conflict of interest cannot be established with regard to the RBI.

K Kanagasabapathy: The RBI is legally not an autonomous institution. It claims often to enjoy a certain degree of operational independence in the area of monetary management. But, in the present arrangement where the RBI is burdened with the responsibility of internal debt management, the RBI's use of monetary instruments especially for liquidity management such as cash reserve ratio, liquidity adjustment facility, and open market operations can be clouded easily by the compulsion to achieve the objectives of debt management such as smooth conduct of the government's market borrowing programme and keeping the government securities' yields under check. Otherwise, how one can explain consistently negative yield of 10 year maturity prevalent in the market in recent times? In that process, the government securities (G-Sec) yield curve which is expected to serve as the benchmark for debt and credit markets in general gets distorted. The interest rate channel of monetary policy is rendered ineffective. In this environment, creation of a separate DMO with independent objectives can definitely help in freeing the RBI from the use of monetary instruments for debt management and to avoid mispricing of government securities yields.

Peeyush Kumar: The argument is self-defeating. It must be appreciated that the debt obligations of the government flow out of its fiscal operations. There is parliamentary control on the fiscal policy, which in turn determines the borrowing obligations of the government. Moreover, under the FRBM regime, levels of deficit are subject to direct legislative control. Subject to these parliamentary controls, debt management is purely an executive function of the government. There is a little sense in talking of an independent debt authority. Presently, debt is managed by the RBI as an agent of the government. If the government so chooses, it can take up debt management directly or through an attached office. In any arrangement, debt functions will by definition continue to be intimately linked to fiscal policy of the government. Therefore, it cannot be argued that independent debt management will better serve the cause of seclusion from the populist measures of the government. On the contrary the RBI may be at arm's length from the government in this respect as compared to any other alternative.

R. K. Pattnaik: There has been some debate in the past on the separation of debt management from the RBI. A perusal of the debate revealed that in the RBI itself there were differences of opinion. Nevertheless, the statement of the then RBI Governor (Dr. Subbarao) against the separation was praiseworthy, particularly in the context of the proposal in the Union Budget 2011—12 to introduce the Public Debt Management Agency Bill. The MOF of the government of India should consider revisiting the whole issue in the light of the governor's public statement and also Deputy Governor Mr. Khan's views expressed in this conference as, globally, there is wide recognition that debt management is no longer a routine exercise. For prudent fiscal, monetary, and debt management, it is advisable that debt management should continue with the RBI. The separation of debt management from the RBI will have an adverse impact on the market. It is pertinent to note that in the dynamic environment created by the introduction of the Liquidity Adjustment Facility (LAF) in 2000 and the prohibition on RBI's participation in the primary market under the FRBM Act, 2003, the primary market interest rates, which are auction-driven, are no longer viewed as interest rate signalling by the RBI. Therefore, the conventional argument that there is conflict of interest does not have much validity. Furthermore, the cost of government borrowings is inextricably linked to the level of fiscal deficit rather than the arrangement for debt management by the central bank. Evidence suggests that the smooth conduct of the government's large borrowing programme has been facilitated because the RBI, apart from being the banker and debt manager to the government, also has a broad range of responsibilities, including regulation and surveillance of financial institutions, financial markets, and market infrastructure.

Ritvik Pandey: If it is perceived that the RBI's autonomy is at risk due to populist policy measures of the central government, it is hard to believe that a newly constituted DMO can maintain its autonomy. Over the years, the RBI has earned its autonomy and independence in the system and would be far more capable of handling populist policy measures than any other body.

CS: *What is the right model for a separate DMO? Should it be with the government, the RBI or an independent debt management body*?

Harun Khan: To put the debate in its historical context, with regard to the location of sovereign debt management functions, a multiplicity of arrangements exist around the world: in the MOF, central bank or autonomous debt management agency. Cross country experience shows that there is no international best practice and the adoption of any particular model could depend on country specific circumstances. In the 1990s, several OECD countries entrusted debt management to separate agencies with the objective of providing monetary policy independence to central banks so that they could concentrate on inflation management and not be impacted by the conflicting objective of raising debt for the sovereign at low cost. It was also perceived that independent DMOs would improve operations of debt management through improved accountability and specialization. Many developed nations have followed suit.

Vijay Singh Chauhan: Debt management function performed by the RBI is an agent-function performed on behalf of the GOI as the principal. In fact the GOI pays debt management fees to the RBI for the same. In such a scenario, the issue also merits consideration from the point of view of the principal's freedom to choose the agent.

Peeyush Kumar: I would like to refrain from voicing a personal opinion in the matter, as I am directly dealing with the subject in my official capacity. Suffice it to say that the government has announced its decision to separate debt functions from the RBI. It is desirable that the government and the RBI work out the mechanism jointly so as to ensure that the emerging structure is ably designed.

R. K. Pattnaik: Debt management should be with the RBI. Independent management and issuance of government debt could distort the sovereign yield curve in a thin market, jeopardizing the monetary signalling and its transmission across the yield curve. In my considered view, a likely outcome of the separation could be the emergence of multiple debt management agencies, *viz* one for the state governments' market borrowings and another for the central government borrowings. What will happen to the public debt offices of the RBI? In such a scenario, coordination among debt managers will be difficult and will eventually lead to conflict and confusion.

K Kanagasabapathy: In creating a new institution for public debt management, the complex nature of government liabilities has to be prominently kept in mind. First, government liabilities include other liabilities besides market debt. Second, it includes both internal and external borrowings. Third is the three layers of government—centre, states, and local bodies. An independent DMO should be able to integrate all these. Apart from central and state governments, the RBI is also a stake holder because of the close nexus between fiscal and monetary management. Therefore, an ideal structure would be an independent statutory body owned jointly by central and state governments and the RBI with arm's length relationship with all these stakeholders. This structure can enable a holistic view of public debt, its sustainability and related risks, and also ensure that governments do not fail to meet the fiscal rules and discipline as demanded by the fiscal responsibility and budget management legislations and related commitments.

CS: *Would a separate DMO help in making monetary policy more independent?*

Harun Khan: The process of managing public debt is an onerous responsibility, with implications for financial stability in the short to medium term and inter-generational equity in the long run. Our debt portfolio is reasonably stable and sustainable and due to our conscious strategy of elongation of maturity, low level of foreign currency debt, and large domestic investor base, risks are at a low level. There is, however, an unfinished agenda of consolidation of public debt and we are moving towards this goal by active debt management through re-issuances, buybacks and switches. More efforts are needed to develop a deep and liquid G-Sec market that allows the government to borrow more efficiently, different classes of investors to enter and exit the market freely, and private sector issuers to price their offerings transparently. We are, therefore, committed to improving liquidity. The RBI has discharged its mandate of managing the public debt in an efficient and effective manner. There is merit in continuance of the present institutional arrangement. If at all separation of debt management from central bank has to be effected, it should be preceded by a well thought strategy focussing on perfect co-ordination among the DMO, the MOF and the RBI.

Peeyush Kumar: The idea of separation of debt functions from the central bank emanated because of inherent conflict of interest between the debt functions and other obligations especially with the central bank's role in targetting inflation through interest rates. Internationally also it is unanimously accepted that there is an inherent conflict of interest. However, there are differences on how to resolve this conflict. While some countries have argued for separation of the two functions, it is also generally agreed that there has to be close co-ordination between the debt management, fiscal policy, and the monetary policy; liquidity management is contingent upon the debt function and has to be calibrated in tandem. Therefore, by definition, the debt manager, the government and the RBI need to work in close co-ordination. It is the institutional arrangement required for this harmonization that is under discussion. Under the existing scheme, RBI manages the debt functions and liquidity internally, with effective synchronization by the government of the former. Once the debt function is segregated from RBI, the policies will have to be synchronized between the Government, central bank and the debt manager effectively.

R. K. Pattnaik: Not necessarily. The RBI has been successfully managing the government borrowing programme with its knowledge and experience in studying market liquidity, investors' appetite and risk constraints, apart from timing of debt issuance in line with its avowed objective of maintaining financial stability. There has not been any empirical research to prove that the monetary policy function has been adversely affected because the RBI is the debt manager. Furthermore, evidence suggests that the cash management of the government has remained poor and inefficient. The RBI, as banker and debt manager, has been helpful in accommodating the deficit and surplus mode, taking into account the absorptive capacity of the market. One doubts if an independent body will have the experience to handle cash management of such magnitude and varying degree. In the post-crisis environment globally, there has been a renewed focus on debt management as being a critical element in the overall conduct for financial stability, as events in Greece have shown. Studies undertaken by multilateral agencies such as the World Bank, International Monetary Fund (IMF) and Bank for International Settlements (BIS) observe that there is merit in leaving debt management with central banks. The BIS study (November 2010) particularly noted that debt management can no longer be viewed as a routine function that can be delegated to a separate, independent body. Instead, such management lies at the crossroads between monetary and fiscal policy. The study further opined that during difficult times, government securities market conditions are better managed by the central banks. In view of this, the study recommended that the central banks should be encouraged to revert to their role of managing national debt. The recent handling of the market borrowing programme by the RBI in a non-disruptive manner in its capacity as debt manager and monetary authority clearly indicates that there exists a strong confluence of interest in debt and monetary management, contrary to the conventional view that there is a conflict of interest. In view of the above factors, it is imperative that debt management continues with the RBI. The Middle Office that has been set up within the MOF may be further strengthened to coordinate and provide technical and analytical input to the cash and debt management committee. The GOI may reconsider the introduction of the bill on Public Debt Management Agency with an emphasis on separation of debt management from the RBI.

K Kanagasabapathy: Operational independence in monetary policy would require some legislative changes. Even in the absence of that, separation of debt management can help making monetary policy more independent than what it is today.

CS: *In the current economic situation, when debt to GDP ratio has been declining, would separating debt from monetary management be useful for India?*

Harun Khan: A point that merits attention is that the proponents of separation, while citing examples from countries which differ significantly with regard to institutional milieu from India, pay little attention to nuances of debt management operations. For instance, domestic debt in the UK is managed by the DMO, whereas external debt is the responsibility of the Bank of England. The whole concept of an "all-in-one debt office" is a theoretical construct rather than a real organisation. It is also important to note that sovereign debt management (SDM) is much more than a mere resource raising exercise especially in a developing country context like ours. The size and dynamics of government market borrowing has a much wider influence on interest rate movements and systemic liquidity. An autonomous DMO, driven by specific objectives exclusively focussing on debt management, may not be able to manage this complex task involving various trade-offs. With regard to autonomous DMOs focussing on specific responsibilities, the experience of European debt managers is instructive. The experience of the DMO in the Euro area (especially Greece, Portugal and Ireland) has been less than satisfactory. The independent DMOs seemed to have been guided by perverse incentives and issued short-term/foreign debt in a disproportionate fashion, intensifying roll-over risk, sovereign risk and financial instability. The debt management strategy and operations have resulted in a skewed maturity profile with balloon payments. For instance, Greece has bunched maturities during 2010—19 with interest payments on public debt constituting nearly 40% of Greece's budget deficit during 2009. Large proportion (above 70%) of debt of Portugal, Greece and Ireland was held by non-residents. As foreign investors turned risk averse and started withdrawing investments, rating agencies downgraded the debt of these countries. The debt management strategy has jeopardized the fiscal situation and financial stability. Therefore, an autonomous DMO focussing on specific objectives, such as cost minimisation in isolation and not in conjunction with other macro-economic policies may result in sub-optimal debt management outcomes. Persistent fiscal deficit warranting huge borrowings, often at the cost of flow of reserves to the private sector, has been the predominant feature of the Indian economy. Increasing borrowings by the government, the central and the state governments, have to be strategically planned and tactically executed keeping in view the market conditions, liquidity situation, and macroeconomic implications. Thus, given the persistently large size of the market borrowings, there is a strong case for confluence of interest between monetary policy and debt management in India. In a situation of excess capital flows requiring forex intervention from the RBI and the consequent sterilization through issuance of government securities under the Market Stabilisation Scheme (MSS), the coordination of debt management with these operations needs to continue. Separation of debt management from the RBI will make it very difficult to harmonize these operations as is done at present.

In India, the genesis of the proposal could be traced back to various committees/working groups, such as Committee on Capital Account Convertibility (1997); Review Group of Standing Committee on International Financial Standards & Codes (2004), Percy Mistry Committee (2007), Internal Working Group on Debt Management, MOF (2008), and finally Financial Sector Legislative Reforms Committee (2013), which suggested separation of debt management from monetary management. During this phase the RBI, while suggesting separation, has made it conditional on attainment of three milestones: development of the G-Sec market, durable fiscal correction, and an enabling legislative framework. It is argued that a separate DMO will help establish transparency, and assign specific responsibility and accountability on the debt manager and could lead to an integrated and more professional management of all government liabilities, with a focussed mandate. The significant impact of government borrowing on the broader interest rate structure in the economy and, therefore, on the monetary transmission process in financial markets, makes it a critical component of the macroeconomic management framework. In such a scenario, central bank involvement in managing the market volatility and market expectations arising out of government debt borrowing becomes necessary. Past experience, reinforced by the recent developments regarding huge market borrowing of the government, has shown the necessity of this approach. Such will be the case even if the central bank is disassociated from the operational aspects of debt issuance. This being so, it is better for the central bank to have hands-on involvement. It is, therefore, imperative that future course of action needs to be decided based on ground realities of our country rather than from an ideological perspective emerging from post-crisis international experience and the fact that the separation of debt management from the central bank could compromise the effectiveness of monetary policy, efficiency of debt management, and stability of financial markets. Therefore, there is a strong case for continuance of present system of central bank managing debt management in India. In case, however, a decision is taken to move the debt management function to a separate unit, it needs to be preceded by well thought out strategy on timing of commencement of its operations, selection of personnel, their incentive structure, performance evaluation benchmarks from the long term debt sustainability points of view and arrangements for perfect institutional and operational co-ordination among the debt management unit, the MOF and the RBI.

Peeyush Kumar: There is no good time for separation of debt functions. Of course, the RBI has raised the issue of high levels of debt and prevailing macro-economic conditions to argue for deferring the segregation of the debt function to a more opportune time, but the merit of this argument is debatable. It is a fact that high levels of government borrowings require active liquidity management by the bank. Since the central bank does not issue its own securities, it may require using government borrowing for market interventions under special circumstances. This brings back the argument that there has to be close and effective coordination between the debt operations and market operations. An independent debt manager leads to another layer in this coordination matrix and may lead to difficulty if this is not managed with dexterity. But that is an argument for better institutional arrangement; the timing of this arrangement is not the issue, It would be critical to design appropriate institutional mechanisms at whatever juncture it is attempted.

R. K. Pattnaik: The Indian economy in the post-crisis period has been characterized by deceleration in growth and persistent inflation. The main contributing factor to such economic malaise is poor fiscal management. Even under the given FRBM Act, the Indian authorities were unsuccessful in adhering to the golden rule of government finance, that is, the elimination of revenue deficit. Thus, the borrowings by the government are pre-empted for meeting current consumption expenditure. The continuation of revenue deficit has adversely affected growth through dissaving of the government. Furthermore, this has led to a lower provision for capital outlay. Inflation management is difficult as the expenditure pattern of the government fuelled the demand side, thereby making monetary policy ineffective. It has also constrained the scope of fiscal space.

As long as revenue deficit remains in the fiscal sector the threat to fiscal deficit and debt continues. One wonders whether the GOI, which has failed to put in place an effective and efficient cash management system, can handle debt management with a separate debt management office. The RBI is right in its recent assertion that the separation of debt management from RBI is a sub optimal choice. In the same spirit one could also argue that fixation of ways and means advances (WMA) limits with mutual agreement, which has largely remained arbitrary, is also a sub-optimal choice. It is important to note that poor cash management practice not only wastes money, but also inhibits the development of local financial markets and undermines the effectiveness of monetary policy. First, the limits could be formula-based as it is for the state governments. Second, in order to even out bunching of receipts from advance income tax payments, a monthly basis system could be considered against the present system of quarterly basis. Third, the receipts given to state governments in terms of grants and tax could be reworked taking into account the cash flows. Fourth, since consolidated sinking fund has not been put in place so far for the GOI, it may be considered, to take care of the repayment system. Fifth, the calendar for market borrowings and treasury bills to a large extent takes care of repayments but it could be reexamined taking into account the cash flow statement. For this to be effective, all the agents have to be pro-active, not leaving the management to the RBI. Sixth, the approach so far has been to treat cash management of GOI and state governments separately. It is appropriate to put in place a comprehensive approach. Seventh, it would be advisable to have an expert committee to review the current arrangements for WMA/overdraft/surplus and prescribe the limits and other related arrangements.

CS: *How do you explain the difference in the fiscal deficit and borrowing requirement of the central government observed in many of the years?*

Vijay Singh Chauhan: In theory, the fiscal deficit of the government will equal the net borrowing (i.e. net of repayment), adjusted for the changes in the cash balances. In the case of GOI, the position is rather complicated. Firstly, central government has a single cash balance account covering the consolidated fund, the public account, and the contingency fund. As you know, fiscal deficit relates only to transactions covered by consolidated fund. Therefore, surpluses in public account reduce the market borrowing requirement. Secondly, the cash balance account of all the state governments and the central government is linked through the mechanism of ad hoc treasury bills. Put simply, cash balance surpluses of state governments get transferred as borrowing to central government. Since, state governments have been running cash surplus for many years now, the market borrowing requirement of central government can be reduced to that extent. Thirdly, there exists the mechanism of Market Stabilization Scheme (MSS) which provides for GOI borrowing in excess of its requirement, at the request of RBI for sterilization purposes. Since borrowed funds are not available for spending and are sequestered, it does not impact fiscal deficit.

CS: *In the pre-crisis period a dominant view was emerging that cash, debt, and liquidity management should be segregated. What are the reasons after the global financial meltdown that led to a predominant shift in that view? What according to you would be the correct approach for India to follow?*

Harun Khan: In the pre-crisis phase, the functions of monetary policy, financial stability and sovereign debt management (SDM) used to be looked upon as an "impossible trinity". Post-crisis, their interdependence is increasingly being recognized. Unlike in the past, central banks' operations are not currently confined to the shorter end but are carried out across the yield curve. Similarly, government debt managers, opportunistically or under compulsion, are increasingly operating at the shorter end. This has intensified the interaction between monetary policy and SDM, warranting greater coordination in the interest of policy credibility and financial stability. Internationally, there has been a rethinking on the issue of debt management by central banks, with scholars like Charles Goodhart articulating that debt management being a critical element in the overall conduct of macroeconomic policy, central banks should be encouraged to revert to their role of managing the national debt. In this context, the cause of coordination is always better served under the same roof than by a separation from the central bank, accompanied by a closer inter-institutional coordination. There could be an argument that coordination mechanism could be designed between the central bank and the DMO either by statute or executive order. The experience of coordination mechanisms between the DMO and the central bank, which are vital for economic management, is however, far from satisfactory and has impacted debt management. There have been instances of failed auctions, in the UK (March 2009) for instance, causing reputation risk for both the authorities. Against this backdrop, it is strongly felt that given the large size of the market borrowings, there is a confluence of interest between monetary policy and debt management in India.

K Kanagasabapathy: Cash and debt management functions are inseparable by definition since it is the need for cash that necessitates borrowings. Also the situation of cash surplus needs to be handled in an integrated manner. Liquidity management is essentially a monetary operation. The liquidity management by the central bank should ensure that the quantum channel of monetary policy operating through its liquidity management is consistent with its tight or easy policy stance. For instance when a tight monetary policy stance is taken it is necessary that the liquidity is also kept tight in the system. If enormous liquidity is provided when the policy stance is tight, it will not ensure effective operation of the interest rate channel. When cash and debt management is combined with liquidity management, then the liquidity management can be clouded by the objectives of debt management. This is one reason why the G-Sec yields get mispriced contrary to monetary policy stance. While liquidity management is to be independent of cash and debt management, it is still necessary that the monetary authority is kept informed of cash and debt flows impacted by the debt management agency's actions since the total liquidity in the system is influenced by movements in cash balances of governments and also primary issuances of government debt. This information sharing will ensure smooth operation of liquidity management consistent with monetary policy stance.

Peeyush Kumar: The US Fed policy of quantitative easing was to a great extent responsible for the bubble that was created in years preceding global financial crisis (GFC). The 2008 crisis was also the result of reckless debt practices adopted by some countries, especially in the European Union. Thus analysis of the financial crisis faced at the global level led to the growing sense that the cash, debt and liquidity management functions must be discharged in tandem by the central banks. It was in some way a reversal of the earlier stance of segregation of these functions, and there was general consensus that there had to effective dovetailing of these policies even when they were being performed separately. India has had a record of prudent financial systems which was demonstrated by the fact that GFC did not have any direct impact on Indian financial markets. There can be no denying the fact that debt policy and liquidity management functions are intertwined and even if they are to be segregated there will be need for synergy in policy. Much depends on the institutional arrangement and its functioning.

R. K. Pattnaik: A very careful decision needs to be taken. One has to note that cash, debt, and liquidity management are public goods. The persistence of large surplus in recent times by the government with the RBI has adverse implications for fiscal policy, monetary and liquidity management, and domestic public debt management. Unlike the cash deficit management, the cash surplus management has not received adequate public attention. This could be because in public policy it is apparently assumed that the emergence of surplus is "good" and deficit is "bad". The persistence of cash surplus also makes debt management difficult. In recent times, there were instances of cancellation of auction of dated securities and treasury bills implying that the calendar of issues becomes redundant and there is a stress on price discovery process in subsequent auctions. We have a Cash and Debt Management Committee which is an excellent institutional arrangement with representatives from the RBI and the government. Further strengthening of this institutional mechanism could be a better option than separation of functions. A few policy options for the consideration of the committee are in order.

First, introduction of an ex ante cash flow statement on a daily basis to analyze the cyclical and structural factors. Second, elimination of structural factors contributing to cash surplus and fixing a limit of surplus for the government in the same manner as WMA.

Third, transferring the investment in 14-day intermediate treasury bills with immediate effect to 'consolidated sinking fund' investment to address the humps in debt repayment in the immediate future. Fourth, advance tax collection on a monthly basis in place of a quarterly basis. Fifth, in order to ensure transparency, the central government and the RBI may consider disseminating data to the public on the modalities of surplus investment, which includes the volume, rate of interest, and maturity. Sixth, one option which needs serious consideration of the authorities is the investment of government surplus in the market through an auction system.

CS: *What are your views on debt sustainability? Is there an internationally accepted benchmark for assessing the sustainability of domestic debt? If not, what is the underlying mechanism adopted by the GOI to identify the threshold range of sustainable debt?*

Benno Ferrarini: International bodies, such as the IMF, have adopted a debt ratio of 40% to GDP as a rule-of-thumb benchmark for emerging markets. Unfortunately, it is far from straightforward to establish a relevant benchmark, or debt limit, that distinguishes a safe debt ratio from a perilous one. Such a benchmark should reflect a country's debt tolerance, that is its capacity to successfully manage fiscal policy as debt rises. But debt tolerance depends on a wide range of country specific factors, including debt structure, hidden liabilities, economic volatility, institutional quality, adjustment record, and default history that are difficult to translate into a benchmark. In the case of India, the benchmark is likely much higher than 40% to GDP. The country's share of external debt is small, which limits exposure to foreign sentiment and discipline about debt sustainability. Moreover, debt financing and management in India is greatly facilitated by the fact that the public sector itself, through shares in banks and insurance companies, holds a significant share of GOI securities. Finally, nearly all of the government debt is in fixed interest loans and the average residual maturity of the central government debt is relatively long by international standards, so the refinancing risk is low. Notwithstanding these considerations, there is no room for complacency and the public debt ratio must be held closely in check. The global financial crisis in 2008 and a marked slowdown of GDP growth more recently underscore the need for continuing policy focus to ensure fiscal sustainability and financial stability, and for further action towards strengthening the practices India employs in managing its public debt.

Peeyush Kumar: There are no internationally accepted benchmarks for sustainable levels of debt. Some advanced economies have very high levels of debt without any major macro-economic instability; while a few countries with relatively lower levels of debt have faced serious crisis. Interestingly, emerging economies generally have more stable debt levels. Debt sustainability has to be viewed in the specific macro-economic framework of the country; pertinently in the context of debt profile, external risk, financial systems etc. In the Indian context, where debt is predominantly exchange-rate shock free and domestically held in fixed tenor instruments, level of debt is not an overwhelming concern. Of more immediate concern is the increasing size of gross borrowing especially with roll-over raising the gross borrowing. With increase in government borrowing, crowding out of private investment has a deleterious impact on the growth cycle. The government has, under the new FRBM regime, limited its borrowing levels to provide impetus to private investment and revival of growth cycle.

R. K. Pattnaik: Our empirical exercise reveals that the tax buoyancy for the centre is around 1.35 and the total revenue buoyancy is 1.17, whereas the expenditure elasticity is 1.22. This indicates that an elimination of revenue deficit in the medium term looks difficult unless tax buoyancy is further increased with emphasis on minimizing the structural component. In non-interest revenue expenditure, the structural component predominates. However, the share of development expenditure in this category is lower than the non-development components. The persistence of revenue deficit accentuates the vicious cycle of deficit and debt. The current debt to GDP ratio at around 50% for India seems to be lower than the European economies, the US and Japan. However, a sheer low number is meaningless until the sustainability factor is suitably addressed by elimination of revenue deficit. In a federal set-up like India, the analysis of fiscal sustainability is incomplete without addressing underlying issues in state finances. Evidence suggests that fiscal consolidation in terms of reduction in revenue deficit has been more encouraging in case of state governments. However, our technical analysis suggests that this improvement has been achieved to a large extent by the Finance Commission (FC) awards. Thus, the indicative ceiling on overall transfer to states on the revenue account is set at 39.5% of gross revenue receipts of the centre on the basis of the recommendation of the Thirteenth FC. Thus, the elimination of revenue deficit will have implication for state finances in terms of the tax devolution to states as well as grants-in-aid to states. For example, the share of grants in the total transfer has come down from 18.9% to 15.1% from the Twelfth to Thirteenth FC.

Ritvik Pandey: While the state debt was relatively steady at around 20—22% of GDP till the year 1997—98, it started increasing sharply after that. The fiscal deficit also remained below 3% of GDP till 1997—98, but increased to 4.5% by 1999—2000. One main reason for this sharp increase was implementation of Fifth Pay Commission report by the states and poor revenue performance by the states. By the end of 2003—04, the debt levels touched almost 32% of GDP. To give a historical perspective, the debt to GDP ratio in 1971—72 was 20% compared to 4% in 1951—52. It came down to 18% by 1983—84 and increased to 20% percent by 1988—89. Therefore, the debt stress witnessed by the states during the first few years of this century was unprecedented and took its toll on delivery of public services. The states found it difficult to even pay salaries and repeatedly faced cash crunch. The debt of the state has to be approved by the central government. This had been the primary source of control over the state debt till the 12th FC recommended that states legislate their FRBM Acts. The 12th FC also mandated states to chalk out a debt consolidation roadmap in accordance with broad targets recommended by it. Later, the 13th FC refined the debt consolidation roadmap and gave a formula for determining the borrowing ceiling of a state by the centre. Normally, the overall borrowing ceiling is decided by the formula given by the 13th FC and then using a projected amount of inflows from other sources, the amount to be raised through Market Borrowings is determined based on which the RBI draws a borrowing calendar. Experience has shown that the debt and deficit levels prescribed by the successive FCs, which now form part of the FRBM Acts of the states have worked well. It is not an easy job to fix an exactly optimally sustainable debt level. However, from a practical viewpoint, a good benchmark is one that is acceptable, implementable, and maintains the balance between affordability and the development needs of the government. To this effect, the current ceilings have passed the test of time.

CS: *What has been the impact of low buoyancy of central transfers and spillover of central pay revisions on state finances?*

Peeyush Kumar: The transfer of funds from the centre to the states has been increasing on two counts. One, successive FCs have been increasing the state's share of devolution, and the centre has been increasing the plan scheme allocations both under the centrally sponsored schemes and central assistance to States. As a result of increasing devolution from the centre, state finances have shown marked improvement. With development functions being largely taken care by the funds from the centre, states have not only adhered to their respective fiscal targets but to a large extent achieved surplus on revenue account, despite pay revisions.

Ritvik Pandey: State finances have seen many cycles of ups and downs since independence and states have adopted different strategies to cope with the financial challenges that they faced from time to time. The states' capacity to deal with the challenges differs widely. While some states are largely self-reliant, others heavily rely on central financial assistance. While some face resource disability due to structural issues, others have been facing problems due to poor fiscal management over long term. Similarly, the cost disabilities faced by each state also differs. These disparities have led to each state being in a different status when it comes to debt and deficit management. While the state finances have been primarily guided by factors such as composition of economy, demography, social development, and geography, there even have been certain one-off events that have had lasting or even permanent impact on a few states. For example, terrorism in Punjab has had almost a permanent impact on the debt levels that the state has been into. There are certain events that have impacted the debt levels of all states but have had different impact on different states depending on their fiscal capacity, such as in the case of pay commissions. Overall, states have evolved their own strategies for debt and deficit management depending on their strengths and challenges. However, there has been some uniformity in their approaches, especially recently, mainly due to the overall legal framework, role of the centre and other central bodies like the RBI and the approach followed by the central finance commissions.

CS: *The FRBM guidelines necessitate significant reduction in fiscal deficit, which may eventually affect government expenditure on the social sector. In this regard, to what extent will the FRBM Act be feasible for an emerging country like India?*

Peeyush Kumar: Fiscal responsibility and budget management is the mechanism of legislative control over debt. It is not only desirable but also essential in a parliamentary system to have such a control on one of the most important parameters of fiscal policy. The constitutional provisions of budgetary control provide for expenditure control but since there is no direct control on revenues, deficit is incidental rather than a principal policy instrument. Fiscal responsibility and budget management brings back the focus on deficit and requires government to determine the size of borrowing upfront. In this sense, FRBM changes the orientation of fiscal policy. Since the turn of this century, it has become the mainstay of fiscal policy both at the centre and state level. In emerging countries like India there is a definite need to provide for welfare and social sectors to cater to the vulnerable sections. However, it is also incumbent on the government to provide the right policy direction to growth to meet the growing aspirations of the nation. Governments have to be responsible enough to provide impetus to growth, which in turn allows access to more resources for welfare measures. There is a fine balance between the competing demands, and FRBM enjoins the government to follow a prudent debt and fiscal policy.

R. K. Pattnaik: The preamble to the FRBM Act 2003 states that it is: "An Act to provide for the responsibility of the central government to ensure inter-generational equity in fiscal management and long term macro-economic stability by achieving sufficient revenue surplus and removing fiscal impediments in the effective conduct of monetary policy and prudential debt management consistent with fiscal sustainability through limits on the central government borrowings, debt and deficits, greater transparency in fiscal operations of the central government and conducting fiscal policy in a medium-term framework and for matters connected therewith or incidental thereto". Fiscal responsibility and budget management is based on the above objectives. Therefore, in the long run it is growth and social sector supportive. The fiscal consolidation through FRBM should emphasize the four Fs of fiscal empowerment (maximize revenue to the budget), fiscal transparency (avoidance of any creative accounting), fiscal marksmanship (maintaining budget integrity avoiding large deviation in the budget estimates, revised estimates and accounts figures) and fiscal space (counter cyclical policies to manage the fluctuations in business environment due to exogenous shocks). If these four wheels are strong the fiscal sector cart will have a smooth run.

Ritvik Pandey: Reduction of deficit does not necessarily mean reduction in expenditure. In fact, in India fiscal reforms have been mainly revenue led. Governments at both levels realized that the revenue realization has been at a sub-optimal level and embarked upon ambitious revenue reforms, many of which were targetted towards fixing tax administration. Expenditure reforms in India are yet to take off full steam. Impact of some of the reforms like the shift to a contributory pension scheme will be visible only after a decade or so. Social sector spending should only be the last casualty of fiscal reforms since many other opportunities exist.

CS: *What are your views on the introduction of the concept of effective revenue deficit in fiscal calculus?*

R. K. Pattnaik: In my considered view, introduction of effective revenue deficit (ERD) is a classic case of creative accounting and is against any norm of fiscal prudence. What are the advantages of ERD? The union budget makes a distinction in functional expenditure categories. Capital grants should not be part of revenue expenditure as it is meant for creating capital assets. What are the disadvantages of ERD? It is against the constitutional provisions of budget making. Annual financial statement (AFS) presented to the parliament according to Article 112 of the Constitution treats all grants as revenue expenditure. Effective revenue deficit suffers from time inconsistency. This was introduced as the GOI realized that elimination of revenue deficit (RD) looks difficult within a span of five years. Fiscal transparency suggests that sudden shocks to accounting arrangements should best be avoided. What are the net implications for the general government finances with ERD? Since grants, whether capital in nature or otherwise, are treated as non-tax revenue receipts, these are in AFS of state governments meant to finance revenue expenditure. To the extent the central government reduces its RD and if these are not treated as revenue receipts of states, the RD of states goes up by similar amount of reduction and has no impact in the general government RD. Since RD is not eliminated, there are macro-economic implications in terms of savings and growth, and the vicious cycle of deficit and debt! Should we abandon the concept of ERD? In the interest of constitutional budgetary accounting coupled with adverse macro-economic implications for savings and growth, the concept of ERD may be revisited and could be dispensed with.

Vijay Singh Chauhan: Deficit is an important indicator of the health of the economy and different measures are intended to highlight different perspectives with which government deficit can be looked at. The GOI plays an important role of a financial intermediary, a role which has been declining over time for a variety of reasons. Thus, loans as an expenditure item have been going down. Significant changes in accounting practices, most important of which is in relation to small savings towards the end of the last millennium, also resulted in the decline in capital expenditure of the government. Effective revenue deficit seeks to address some such concerns.

Peeyush Kumar: The first version of FRBM, which was enacted in 2003 required elimination of RD while limiting the fiscal space. However, it was soon realized that there are certain problems in this approach essentially due to the federal nature of our financial system. As per accounting standards, all transfer payments are treated as revenue even when the amount is used for creation of capital assets. In other words, elimination of RD meant severe restrictions on the centre's ability to borrow resources even for capital spending in the states. This required the centre to deploy only balance from current revenues for development purposes which was greatly constrained due to other compelling demands. It was felt that the FRBM regime was too restrictive and needs to be rationalized. Thus, in the new FRBM regime, the concept of ERD has been introduced defined as difference between the RD and grant-in-aid for creation of capital assets (GIA Capex). By limiting RD below 2% and setting the goal for elimination of the ERD, the new version of FRBM provides for scope of mobilizing additional resources which can be exclusively set aside for the creation of capital assets in the field. Given the federal nature of government structure and accounting treatment of transfer payments, ERD is a novel approach to allow borrowings for capital use. It addresses the quality of government spending while keeping quantitative tap on borrowing levels.

Ritvik Pandey: The concept of ERD is the least understood concept and has been attracting unnecessary criticism. It has been widely acknowledged that the fiscal reform strategy should consist of twin efforts of reducing the fiscal deficit and eliminating the revenue deficit. While the first focusses on the quantity of debt, the second focusses on the quality aspect, that is, do not incur revenue expenditure out of borrowed funds but only create assets out of borrowed funds. If we accept this as a viable and desirable strategy, the problem at hand is the distortion associated with the revenue deficit, especially given the peculiar nature of the fiscal federal structure that involves a large amount of fiscal transfers. In the current context, grants for a scheme like Pradhan Mantri Gram Sadak Yojana (PMGSY) are classified as revenue expenditure although it leads to creation of assets in the economy. Similar is the status of Accelerated Irrigation Benefit Programme and many other such programmes.

If RD has to be reduced, outlays under these schemes also have to be reduced, which defeats the purpose as the purpose is to divert more resources towards capital expenditure. Therefore it is desirable to devise a parameter that excludes these kinds of expenditure and target elimination of that parameter. The argument made in response is that the asset so created does not 'belong' to the central government. This is an extremely misplaced notion as the assets created by any level of government 'belongs' to all levels of government. The returns on government's investments come in the form of higher economic growth and therefore higher revenues. To that effect, it is irrelevant which level of government builds roads or dams, it will eventually have the same effect on industrial or agricultural growth. The question of implementation should be left to considerations of efficiency. It is better if the central government builds rails, state governments build state highways and panchayats implement PMGSY, but the impact of all these on the economy would be the same. If the central government itself would have implemented PMGSY, it would have been out of the RD definition and just because it transfers that money to panchayats, it gets included in the RD. Therefore, to meet the requirement of 'create assets out of borrowed funds', it is better to devise a parameter that is independent of the 'implementation question'. This purpose is served by the ERD.

Contrary to what is claimed by many people, ERD is hardly an accounting parameter. It is more of an economic concept. While this correction may not be relevant for countries that have occasional fiscal federal transfers, it is extremely critical for a country like India where federal transfers are substantial and are of all types. It makes the parameter more focussed. While some more distortions in the RD may still exist, it is at least one less.

CS: *The Financial Sector Legislative Reforms Commission (FSLRC) Report recommends setting up of an independent debt management agency. Do you think the draft "code" in its present form will ensure the desired independence?*

K Kanagasabapathy: While the report of the Commission in its first volume recommends an independent debt management agency, the draft code presented in the second volume does not reflect either in spirit or letter the intention of the Commission in its first volume. The FSLRC envisages an independent public debt management agency (DMA) combined with a specialized framework on public debt management. The draft code is intended to create a specialised statutory public debt management agency that is equipped to manage the liabilities of the government in a holistic manner. This agency is expected to have independent goals and objectives — but as an agent of the central government. The DMO is to be guided by an advisory council and run by a management committee with representation from the RBI and the central government. The principles of governance, including transparency and accountability, will apply to all functions of the agency, its committee and council. The draft code however deprives both management committee and the advisory council of any independent functioning. The DMA will function under the overall superintendence of the finance ministry and will have to necessarily follow the instructions of the central government. Thus, the DMA has been made subservient to the ministry and will not enjoy any independence. In the proposed arrangement, there is potential for the ministry to interfere in the day to day functioning of the DMA. The existing arrangement where the RBI performs the debt management function seems to be more independent than the proposed DMA.

Peeyush Kumar: As stated above, 'independent' debt management is a misnomer. By definition debt policy is intimately linked to, in fact is part of, the fiscal policy. There can be various legislative controls on the policy but it cannot be conceptually independent. The debt functions are an integral part of the government functions. Thus, there are examples of government, and through it the treasury department, directly discharging the debt functions or through an attached office. Alternately, in some countries including India, the central bank performs this function. Independence here refers to the operational aspect of the debt management, rather than the policy part, which needs some expertise. Since such expertise is difficult to develop in the ministries the preferred option is either through the central bank or an attached office with independence in market operations. Such independence is there under the existing system with the RBI and has been sufficiently built into the proposed system.

CS: This brings us to the close of our round table discussion. There are a number of issues involved in separating debt from monetary management. In the initial years, it was the RBI which was suggesting that the separation would be helpful in policy making but in recent years, probably because of the financial crisis of 2008 the RBI does not consider the separation as appropriate. In the literature and as per the empirical literature, many countries have separated debt from monetary management to pursue focussed objectives of debt and monetary management separately. The separation will help the interest rates to be market determined, as well as force the government to expand investor base to mobilise additional resources to meet the ever expanding demand from the rising fiscal deficits.

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