That is Retrograde, Mr Jaitley

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An important step in clearing our institutional financial system of the cobwebs it has gathered over the years has now been reversed, with Mr Jaitley announcing to defer his plan to set up an independent public debt management authority, which he had promised in the budget presented earlier this year. Till now, Reserve Bank of India (RBI) has been managing the market borrowings of central and state governments, while external debt which is vulnerable to the volatility of forex market is managed directly by the central government. While internal and external liabilities are thus managed by different agencies, no particular agency is responsible for overseeing the management of cash, investments and contingent liabilities of the union and state governments. The existing arrangement has created lots of aberrations including fictitious liabilities entering into government accounts, besides inept cash and debt management, with the result that governments are forced to borrow from market to finance their fiscal deficits while sitting on piles of cash.

The level of public debt in the country stood at 66% of GDP as on March 2013, more or less at the same level as in 1990-91 (69%). Domestic debt constitutes as much as 63% of the total public debt. As agent of the union and state governments, while the RBI is empowered under Section 21(2) of the Reserve Bank of India Act, 1934, to manage the public debt of the Union, it manages the public debts of the state governments by agreement with them, under provisions of the Government Securities Act, 2006. As debt manager to governments, it determines when government bonds are to be issued and their respective sizes, interest rates and maturity profiles etc. But its debt management objectives are influenced by its monetary policy interventions in the form Cash Reserve Ratio, Statutory Liquidity Ratio and the Liquidity Adjustment Facility which consists of repo rate which the client banks pay to the RBI for short term borrowings and reverse repo rate which the RBI pays to the banks.

There are, in fact, too many conflicts of interest in the existing arrangements. RBI is the regulator of banks. Besides being the issuer of government securities, it is also the regulator of securities market of which banks are the largest purchasers. As monetary authority of the country, it sets the interest rates for these securities. As the manager of domestic public debt, it can thus sell the bonds at higher prices by keeping the interest rates low and force banks which are captive buyers in the securities market to buy these bonds. This introduces an inherent inflationary bias in the monetary policy and prevents the market from determining the actual prices of these bonds based on their fundamentals that depend on the strength of finances of the central and state governments. Further, Government's ownership of more than 60% of the banking sector assets introduces further conflicts of interest, just as higher borrowings to finance larger fiscal deficits of the governments would have their corresponding monetary implications.

In fact, RBI itself was the first to recognise these serious conflicts of interest, as pointed out by many of its in-house committees and working groups. The Committee on Capital Account Convertibility (1997), Working Group on the Separation of Debt Management from Monetary Management (1997), Advisory Group on Transparency and Financial Policies (2001), RBI Annual Report (2001) and an

Internal Expert Group (2001) have all suggested setting up of an independent and autonomous Debt Management Office. Report of the Standing Committee on International Financial Standards & Codes (2002) had observed that RBI's responsibilities in the areas of monetary policy and internal debt management had "led to a situation of monetary policy function becoming somewhat subservient to debt management. Debt Management function puts RBI in a situation of direct conflict of interest." Partially to address this, FRBM Act of 2003 had prohibited the RBI from purchasing primary issues of the central government securities from 2006, preventing monetization of government deficit.

In 2006, the Committee on Fuller Capital Account Convertibility recommended setting up of an independent Office of Public Debt. Then, following the recommendations of the Percy Mistry Committee in 2007, in the Union budget for 2007-08, Mr Chidambaram had proposed to set up an autonomous Debt Management Office (DMO) outside the RBI. As an interim step, a Middle Office was created in the Ministry of Finance pending transition to a full-fledged DMO.

The Internal Working Group on Debt Management (2008) headed by Mr. Jahangir Aziz suggested creating a 'National Treasury Management Agency', by combining debt and cash managements together with the management of contingent and other liabilities, and also to integrate these functions with risk assessment and other advisory functions. In the same year, Raghuram Rajan Committee on Financial Sector Reforms also recommended establishment of an independent DMO.

Finally, in 2013, the Financial Sector Legislative Reforms Commission (FSLRC) headed by Justice B N Srikrishna reiterated the recommendations of the 2008 Working Group Report to separate debt management from monetary management and to integrate the management of cash and contingent liabilities of the government with debt management, and making a single agency, called Public Debt Management Agency (PDMA), responsible for all these functions. Accordingly, in the union budget for 2015-16, Mr Jaitley announced the creation of PDMA by repealing the Government Securities Act, 2006 and amending the RBI Act, 1934 and other relevant legislations, thereby taking away RBI's powers to regulate interbank repo and reverse repo rates and shifting the regulation of government securities and money market instruments to SEBI. Simultaneously, RBI was given the task of inflation targeting under an MOU with the Government. Inflation targeting which should be the priority of RBI as the monetary authority, would be impossible without dissociating it from debt management functions, as otherwise there always be a conflict of interest between controlling inflation and keeping the interest rates low so as to reduce the cost of government borrowings. RBI will of course continue to act as banker to all Governments, while its debt management functions would stand transferred to the PDMA.

The setting up of an independent PDMA was one of the most welcome features of Mr. Jaitley's budget. But sadly, for reasons as yet unexplained, he has reneged on his promise and the entire process has now been put in the reverse gear, on the ground that a detailed roadmap needs to be set up for this. Political support was not lacking, and PDMA being part of the Finance Bill which is a money bill, neither was there any fear of defeat in the Rajya Sabha. An independent PDMA would have sent strong signals about the government's intention to usher in serious reforms and create greater transparency in the domestic bond market, which could then be integrated into our vibrant capital market and derivatives market, unifying and creating a common financial market. Today the banks hold much more government bonds than required by the Statutory Liquidity Ratio; delinking the RBI from debt management would also have freed up resources for banks to increase their profitability through higher volumes of commercial lending.

There are of course defenders and sympathisers of the RBI who do not like to see a shrinking of its role and its diminishing importance in the administration of financial markets in the country. They cite the example of Greece and argue that debt management cannot be viewed as a routine function to be delegated to a separate agency and that RBI has facilitated large borrowings of governments in a smooth and non-disruptive manner, which has led to improvements in securities trading and settlements with much lesser risks and transaction costs. They advocate a gradual and calibrated roadmap for separation of the functions rather than setting up of a PDMA straightway.

International best practices can probably serve as a useful guide in this contentious debate. Most developed countries like the OECS countries have long back taken debt management out of the purview of their central banks. Emerging economies are also falling in line; Brazil, Argentina and South Africa have restructured their debt management and created independent agencies for managing their debts. None of these countries has so far reverted the debt management functions back to their central banks. In any case, an institutional coordinating mechanism can be established between the RBI and the PDMA to prevent a Greece-like scenario, possibility of which is rather far-fetched in the Indian situation; such coordination would also contain the fallouts from any future market volatility.

A large part of the country’s infrastructure building requirements has to come from the bond market. But the bond market, dominated by a limited number of players – mostly commercial banks and financial institutions- itself remains weak and undeveloped due to the same constraints of conflicting interests. Unless reformed, the bond market will not be able to attract the large pool of private savings which today are going elsewhere, e.g. real estates and gold. PDMA is the need of the hour, much beyond the jurisdictional considerations of RBI or the Finance Ministry.