ILLUSTRATION: BINAY SINHA

Dealing with RBI's policy dilemma

Separation of public debt management from monetary policy is necessary for resolving conflict between two competing policy objectives

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In the absence of evidence on revival of private sector investments, the strategy of the latest Budget is a government capital expenditure-led process to kick-start the post-pandemic growth cycle. This is expected to "crowd-in" private investment in the medium term. The increased government expenditure will be funded by a larger public borrowing programme, carried out by the government's debt manager, the Reserve Bank of India (RBI).

Are there risks inherent in this strategy? How can they be mitigated? The RBI was established in 1934. Like many central banks of its times, in the early years of the Indian republic, the RBI played an important role in the financing of development. When the five-year plans began, it was instrumental in setting up many financial institutions, including as part owner. Over time with the development of financial markets, recognising the inherent conflicts of interest, the RBI has been moving out of many of these functions.

Despite many decades of public debate, it was only in February 2015 that the Monetary Policy Framework agreement was signed, and in September 2016 the RBI was mandated by law to maintain price stability while keeping in mind the objective of growth. The Monetary Policy Committee of the RBI is entrusted with the task of fixing the benchmark policy rate required to contain inflation within the specified target level— notified for 2016-2021 to be 4 per cent with a 2 per cent upper and lower tolerance levels. While this clarified the institutional objective of the RBI, it exacerbated another conflict in the working of the RBI, namely its role as the manager of public debt.

There are three issues that are relevant in the design of public debt management in India. These are consolidation, conflicts of interest and financial repression. In a well-structured debt management system, all information about onshore and offshore liabilities, and contingent liabilities, is centralised into a single database. Unification of all information leads to better decisions in debt management. At present, fragmentation of information and decisions lead to suboptimal outcomes. A consolidated debt manager that deals with all government borrowing, and understands the entire portfolio, is better at coordinating borrowing and managing risk.

Having the central bank manage public debt generates a series of conflicts, which have negative effects on economic and financial policy. First, there is a severe conflict of interest between setting the short-term interest rate (i.e., the task of monetary policy) and selling bonds for the government (i.e., the task of investment banker of the government). If the central bank tries to be an effective debt manager, it would lean towards selling bonds at high prices, i.e., keeping interest rates low. This leads to an inflationary bias in monetary policy.

Where the central bank also regulates banks, there is a further conflict of interest. If it tries to do a good job of discharging its responsibility of selling bonds, the central bank has an incentive to mandate that banks hold a large amount of government paper. This bias leads to flawed banking regulation and supervision, to induce banks to buy government bonds, particularly long-dated government bonds. Having a pool of captive buyers undermines the growth of a deep, liquid market in government securities, with vibrant trading and price discovery. This, in turn, hampers the development of the corporate bond market — the absence of a benchmark sovereign yield curve makes it difficult to price corporate bonds. Additionally, when banks are fragile, and own a lot of government bonds, the central bank, in its role as bank regulator, is loath to raise rates as this will impose mark-to-market losses upon the banks.

Separating debt management from the central bank addresses these conflicts. International experience also shows that there are important gains from this separation. In this framework, the central bank focuses on monetary policy, on modifying the short-term interest rate to stabilise the domestic business cycle. The debt management office works as the "investment banker" for the government, selling bonds and engaging in other portfolio management tasks in close coordination with its client, the budget division. Each of these agencies then has a clear focus, specialised professional skills are built up and conflicts of interest are avoided.

Why is this institutional design discussion relevant today? The total public sector borrowing is projected by this budget at 11 per cent of the gross domestic product (GDP). In absolute terms, the gross borrowing by the government in the coming fiscal year will be ₹14.2 trillion, considerably up from ₹10.5 trillion this fiscal. Government debt is already at 90 per cent of GDP and the annual interest payments are at 3.5 per cent of GDP. The current stock of outstanding government securities (G-Secs) is a little over ₹80 trillion and the RBI with about 17 per cent of this is the second largest holder of G-Secs after the financial institutions.

Retail inflation measured by the Consumer Price Index (CPI) was 6.01 per cent in January 2022 as against 5.66 per cent in December 2021. Core inflation i.e., CPI without food and fuel continues to be high at over 5.8 per cent (in January 22 and December 21). The wholesale price index growth continues to be in double digits.

Is it then fair and appropriate to ask the RBI to battle the objective of lower cost of government borrowings against the (now statutory) institutional objective of price stability?

Based on the recommendation of the Tarapore committee way back in 1997, as well as the RBI board in 2001; and reiterated by numerous expert committees since then, the setting up of a Public Debt Management Agency (PDMA) was announced in the budget speeches of 2007 and 2015. The Finance Bill, 2015, laid out the detailed statutory provisions. When the then governor of RBI publicly opposed the move, the then finance minister (FM) rolled it back. However, while announcing the roll-back in Parliament, the FM promised a detailed road map for separating the debt management functions and market infrastructure from the RBI. It is time for the government to redeem this solemn promise to Parliament to create a PDMA for prudent public debt management and enable the RBI to do its dharma of maintaining price stability.

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