INDIA’S RISING DEBT CHALLENGE

Analysing the fiscal deficit levels and mounting debt challenges…

InfoSphere
A Centre for New Economics Studies Initiative

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The COVID-19 crisis has dealt a heavy blow on a country’s health infrastructure and economy. Union Governments across the world have responded with multiple rounds of countercyclical measures-to boost spending or liquidity injection, resulting in a steep increase in fiscal deficit and overall debt.

The Indian Government, however, only increased its direct government spending by approximately 1% of its GDP even after downward-moving growth prospects. Moreover, international credit rating agencies like Moody’s recent downgraded of India’s overall ranking due to concerns of increased debt.

We analyse India’s fiscal deficit volume and its overall debt-composition in this InfoSphere Issue

*Moody’s is a credit rating agency that ranks creditworthiness of a borrower using standardized ranking scale that measures the expected investor loss in the case of default in repayment of debt.
This InfoSphere Issue shall focus on:

1. Analysis of current Debt and Deficits,
2. Analysis of the recommendations given by the Fiscal Responsibility and Budget Management (FRBM) review committee,
3. Structure and Composition of Public debt in India,
4. The relationship between market borrowings, reserve money and fiscal deficit and inflation,
5. Open Market Operations and

Source: WorldPress.com
Glossary

**Balance of Payments** – records all international trade and financial transactions made by a country’s residents.

**Fiscal Deficit** – condition when government’s expenditure exceeds its receipts in a given fiscal year. Typically calculated as a % of GDP.

**Revenue deficit** – when government’s own earnings are not sufficient to meet the day-to-day operations of its departments.

**Revenue Expenditure** – payment of salaries, pension, interests, expenditure on administration, defence, health, and other services in the country.

**Revenue Receipts** – Tax receipts including income tax, corporate tax, custom duties, excise and other duties levied by the government and non-tax revenue receipts such as interest and dividends on investments made by the government.

**Debt-GDP ratio** – ratio comparing the country’s sovereign debt to its economic output (measured in terms of GDP).

**Monetary Policy** – Central bank activities directed towards influencing quantity of money and credit in the economy.

**Fiscal Policy** – Government decisions about taxation and government spending.

**Counter cyclical measures** – a fiscal strategy of the government to suppress or alleviate economic overheating or recession (in times of economic contraction, an increase in expenditure and reduction in revenue is a counter-cyclical measure).

**Open Market Operations (OMO)** - purchase and sale of government securities (G-Secs) and treasury bills by RBI to smoothen liquidity.

**Bond Yields** – Rate of return on a bond. Bond prices fluctuate daily and hence yield also fluctuates based on bond prices. When price goes up, yield goes down and vice versa.

**Reserve Money** – A sum of currency in circulation, banker’s deposits with RBI and other deposits (deposit with foreign central banks, financial institutions) with RBI.

**Monetization of debt** – Reserve Bank of India (RBI) directly purchases government securities in the primary market to help the central government meet its expenditure, by printing more money at the cost of high inflation and currency depreciation. This practice was phased out and ended in 1997.

To know more: [https://economictimes.indiatimes.com/definition/category/Budget](https://economictimes.indiatimes.com/definition/category/Budget)
Time Line for FRBM Acts

1. Fiscal deficit at 6% of GDP
2. Revenue deficit at 0% of GDP
3. Restricted government from borrowing from RBI.

Balance of Payment Crisis (1991)
Fiscal Responsibility and Budget Management (FRBM) Act 2003
Financial Crisis (2009)
Taper Tantrum (2013)
Amendment FRBM Act 2018

General government Debt at 60% of GDP
AMENDMENT TO FRBM ACT 2018- KEY TAKEAWAYS

- Medium term target for fiscal policy **shifts from fiscal deficit to debt**; fiscal deficit would be an intermediate target.

- Revenue deficit surplus creation scrapped from the act.

- Debt recommendation at 60% of GDP; central government debt to be 40% of GDP and state government debt to be 20% of GDP.

- Contingency liabilities may become high as economy goes into business cycle downturn.

To know more: https://dea.gov.in/sites/default/files/Volume%201%20FRBM%20Review%20Committee%20Report.pdf

**Recommended Path of Debt and Deficit for Central Government:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Debt to GDP (%)</th>
<th>Fiscal deficit (% of GDP)</th>
<th>Revenue deficit (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY17</td>
<td>49.4</td>
<td>3.5</td>
<td>2.30</td>
</tr>
<tr>
<td>FY18</td>
<td>47.3</td>
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<td>2.05</td>
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<td>FY19</td>
<td>45.5</td>
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<tr>
<td>FY20</td>
<td>43.7</td>
<td>3.0</td>
<td>1.55</td>
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<tr>
<td>FY21</td>
<td>42.0</td>
<td>2.8</td>
<td>1.30</td>
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<tr>
<td>FY22</td>
<td>40.3</td>
<td>2.6</td>
<td>1.05</td>
</tr>
<tr>
<td>FY23</td>
<td>38.7</td>
<td>2.5</td>
<td>0.80</td>
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</tbody>
</table>

Source: FRBM Review Committee Report
The Central Government has been constantly missing the targeted debt-to-GDP ratio. Increase in public debt can crowd out private sector borrowing hampering growth. Growth in the economy is associated with increase in revenue receipts; reducing future debt.

Source: Article IV Report, FRBM Review Committee Report
• Debt-to-GDP ratio has remained consistently above the required 60% - the medium-term target.

• Since the global financial crisis, government has failed to meet its Fiscal deficit target of 6% of GDP, year after year.

• The target was met only for 2 years after the enactment of the FRMB act - 2005-06 and 2006-07.
Post 2007-08, Union government failed to bring Revenue Deficit down to zero, in accordance with FRBM 2003.

Following the financial crisis of 2009-10, revenue deficit witnessed a steep increase to 5.8% of GDP in FY 2009-10 and on an average remained in similar range.
On Regressing Effect of Debt and Revenue Deficit on Indian GDP Growth rate, we find that

With a unit increase in

1. Square of debt, GDP growth rate decreases by $2.98312 \times 10^{-14}$
2. Revenue deficit, GDP growth rate decreases by 0.77

This results are significant at 95 per cent confidence level.

The high Debt-to-GDP ratio increases the yield (interest) rates of government bond. This in acute case when the yield rates are higher than GDP growth rate, the issue of solvency could crop up. However, the regression shows there is very little change in the growth rate due to debt as historically, yield rates have never crossed the growth rate of GDP.

Refer to results in the last slide
Average Debt (% GDP) for similar Emerging Markets

Fiscal Deficit (% GDP) for similar Emerging Markets

Source: FRBM Review Committee Report
Why is India’s Debt so high?

- Adverse impact on yields on Government Bonds, increasing Interest Rates
- Constrained monetary policy and fear of rising inflation
- High Revenue Expenditure by the Government
- Increased revenue deficit in turn expands Fiscal Deficit
- Creates a situation of Fiscal Dominance and High Debt-to-GDP Ratio

- Debt at an average of 70% of GDP, higher than recommended level of 60% of GDP
- Post COVID-19: Unemployment increases, Industries came under stress and Growth declined. A requirement to spend as counter cyclical measure
- Debt estimated to rise to 85% of GDP (Moody's) and future government spending restricted.

Increased revenue deficit in turn expands Fiscal Deficit
STRUCTURE OF PUBLIC DEBT IN INDIA

Public Debt

- Internal Debt
  - Marketable Securities
    - Government Securities and Treasury Bills
  - Non-Marketable Securities
    - Small Savings, State Provident funds, reserve funds, state deposits

- External Debt
COMPOSITION OF PUBLIC DEBT IN INDIA

- Internal Debt for Government of India largely consists of dated securities and treasury bills up to 364 days of maturity.

- The share of Marketable instruments constitutes
  - 78.7% of Public Debt
  - 68.8% of Total Liabilities
  at end-March 2019.

To know more:
https://m.rbi.org.in/Scripts/PublicationsView.aspx?id=14939

Domestic and External Liabilities of Centre (as a % of GDP)

Domestic liabilities of Centre
External liabilities of Centre

Source: RBI
COMPOSITION OF PUBLIC DEBT IN INDIA

Financing of Fiscal Deficit

- External finance
- Market borrowings
- Other borrowings
- Draw down of cash balances

Source: RBI
Financial Crisis (2007-08)
- RBI had a tight liquidity situation that was eased by raising foreign exchange by enabling public sector oil marketing companies to sell oil bonds to RBI.
- However, due lack of liquidity in oil bonds, RBI had to intervene by creating reserve money.

Taper Tantrum (2012-13)
- The size of the government’s net market borrowing program (dated securities) increased nearly 9.7 times in eight years to Rs. 4.9 trillion in 2012-13.

The sheer amount of borrowings could still put pressures on monetary policy.

To know more: https://m.rbi.org.in/Scripts/PublicationsView.aspx?id=14939

Source: RBI
INFLATION AND PUBLIC DEBT

- Higher Fiscal deficit
- Higher borrowings
- Higher interest rates
- Reduces Private sector investment (crowding out)
- Pushes price levels up

WPI and Market Borrowings

Source: RBI
As of March 2019, RBI owns 15.30% of G-secs.

A portion of G-secs is held by the RBI. Increases in ownership due to debt financing, can invariably lead to monetization through the secondary market.

Government deficit leads to incremental reserve money creation, even without auto monetization.

Increase in reserve money

Expansion in money supply

Inflation

Source: RBI
• The first announcement to conduct special OMOs was in December 2019.

• However, after the budget announcement in February 2020, the 10-Year bond yields fell sharply.

• The RBI backed the fall in yields by announcing the revised liquidity management framework.

• The 10-year bond yields fell further post the announcement to 6.5%.

• It was the combination of the policy easing and the liquidity measures that caused yields on G-Secs to drop to their lowest level in more than a decade.

To know more: https://m.rbi.org.in/scripts/BS_ViewBulletin.aspx?id=19658#B1
CONCLUSION

• In India, traditionally, a large amount of debt was monetized, and fiscal domination left very little space for monetary policy to manoeuvre and private investment.

• Even today, India has failed to stay fiscally disciplined. In the wake of the Covid crisis and lockdown measures imposed, the limited fiscal capacity of the government has left the economic condition far worse, giving the government limited options to increase spending and boost economic activity.

• The Central bank (RBI) to mitigate the situation has extended liquidity into the economy while provoking capital flight, inflationary pressures and other negative reactions.

• The G-Sec market has remained resilient and stable owing to targeted interventions from the Reserve Bank comprising outright OMO purchases of ₹1.61 lakh crore and other long-term operations. However, as long as RBI keeps government bonds on their balance sheet, a part of government debt will be explicitly monetized.

• Subdued fiscal response when aggregate demand has slumped and resorting more to monetary measures might only worsen the debt-to-GDP ratio of the country. Hence, more fiscal-monetary policy coordination is required to scale up the policy responses to recover from the crisis and achieve economic stability.
The regression is of debt square and revenue deficit on GDP growth rate. The choice of variables are from the regression done by the FRBM committee report 2017. These variables show that India has taken policy to improve its GDP growth while undermining the sustainability of this growth in the long run.

Results of the regression analysis conducted:

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<tr>
<th>Regression Statistics</th>
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<tr>
<td>Multiple R</td>
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<tr>
<td>R Square</td>
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<tr>
<td>Adjusted R Square</td>
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<td>Standard Error</td>
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<td>Observations</td>
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<table>
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<tr>
<th>Coefficients</th>
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<tr>
<td>Intercept</td>
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<tr>
<td>Debt^2</td>
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<tr>
<td>Revenue Deficit (%)</td>
</tr>
</tbody>
</table>

GDP
For any inputs, comments or clarifications please contact The Centre for New Economics Studies at cnes@jgu.edu.in.

Thank you!