

CHAPTER

14

AD HOC TREASURY BILLS

INTRODUCTION

In practice, the tool of deficit financing became a permanent source of financing the Government budget through automatic creation of *ad hoc* Treasury Bills whenever government's balances with the RBI fell below the minimum stipulations. Over the early phase of planning *ad hoc* Treasury bills acquired great significance.

Apart from the routine credit to top the Central Government's stipulated minimum balances, the Reserve Bank also created additional *ad hoc* Treasury Bills at the instance of the Government, whenever the latter was required to hold larger cash balances. As there was unbridled expansion of budget deficits and the Government was not in a position to redeem the *ad hoc* Treasury Bills, the Reserve Bank was saddled with a large volume of these Treasury Bills in its Issue Department balance sheet. Hence, the *ad hoc* Treasury Bills were periodically funded into dated securities from July 1958 under the condition that the Reserve Bank would transfer higher profits earned on account of additional interest income from such conversions.

Reserve Bank's Financing of Budget Deficit

(Rupees crore)

<i>Period</i>	<i>Ad hocs created</i>	<i>Ad hocs Cancelled</i>	<i>Net ad hocs Created</i>	<i>Ad hocs Funded</i>	<i>Net after funding</i>
1	2	3	4	5	6
I Plan	350	10	250	0	250
II Plan	1,975	1,030	945	500	445
III Plan	2,430	1,630	800	275	525

Source: G. Balachandran, The Reserve Bank of India, 1951-67, 1998.

The chapter discusses the origin and growth of Treasury Bills till they discontinued in 1997-98.

TYPES OF TREASURY BILLS

Treasury Bills (TBs), the principal instrument of short-term borrowing by the Government, occupy an important position in the Indian money market. At present, two types of TBs are marketed in India: the 91-day TBs and the 364-day TBs. The 91-day TBs are further of two types: ordinary and *ad hoc*. Ordinary TBs are issued to the public and the RBI for enabling the Government to meet the supplementary short-term finance needs. *Ad hoc* TBs, also called as “ad hocs”, are created in favour of the RBI.

THE EVOLUTION

The evolution of *ad hoc* TBs can be traced back to 1940-41. During the War, the Government of India had to spend substantial amount on account of its defence needs and needs of the Allied Governments. However, the Government of India was to be reimbursed the expenditures incurred on latter’s behalf. These reimbursements came in the form of sterling, which could not be immediately utilised by the Government of India. It, therefore, become necessary for the government of India to find the Rupee resources of meeting the war expenditures, and this was achieved by transferring the sterling to the RBI against Indian Rupees. The acquisition of a sizeable amount of sterling presented an opportunity for quick repatriation of substantial sterling debt, which had accumulated form the mid-19th century. Since the sterling used for repatriation of the Government of India debt belonged to the RBI, methods had to be evolved to provide the Bank with alternative eligible rupee assets. The rupee finance was provided partly by the issues of *ad hoc* TBs, which were retired when the government later launched the dated securities for loan financed programmes.

Ad hocs in effect represent the automatic monetisation of Government’s budget deficit.

AD HOC TREASURY BILLS

BOX: 14.1

The origin of *ad hoc* Treasury Bills in India dated back to World War II when they were issued by the Government of India to the Reserve Bank mainly in connection with the temporary financing of sterling debt repatriation. Since the Government’s receipts through rupee loans did not always coincide with the repatriation of sterling debt, *ad hocs* were issued to provide the Reserve Bank with alternative eligible rupee assets. The *ad hocs* were retired when the Government’s dated securities programme was subsequently undertaken. by *Ad hocs* were also created in 1948-49 to replace sterling securities transferred to the U.K. Government in terms of the sterling balance agreement of 1948.

The origins of *ad hoc* Treasury Bills to finance Government deficit can be traced to the First Five Year Plan, although their volume was to be limited to the extent that it was non-inflationary. However, an operational arrangement in early 1955, which was reached between the Government of India and the Reserve Bank of India, enabled automatic creation of *ad hoc* Treasury Bills to restore Central Government’s cash balance to the minimum stipulated level whenever there was excess cash drawn down. Thus, *ad hoc* Treasury Bills were being automatically created when the Central Government’s actual balances fell short of the stipulated minimum level) (` 50 crore on Fridays and ` 4 crore on other days at that time) but were cancelled on replenishment of the balances up to the stipulated level.

Although this was deemed to be a temporary arrangement, from 1958 the *ad hoc* Treasury Bill financing as well as their funding into dated securities had become a regular feature. 'Funding', in general, refers to the consolidation of public debt by issue of 'funded' debt, *i.e.*, long-dated or undated securities' in place of 'floating' debt, *i.e.*, Treasury Bills and ways and means advances (RBI, 1983). The problem of automatic monetisation was compounded as large amounts of *ad hocs* were rolled over and from 1982 were converted to undated non-marketable special securities carrying a discount rate of 4.6 per cent. Initially, the Government's conversion of the outstanding *ad hocs* into dated securities was in the range of ` 50-100 crore a year till 1981. Since 1982 there was not only a spurt in such conversions but also a fundamental change in the basic characteristics. While the earlier conversions were in the form of Government dated securities with specific maturities at varying interest rates, after 1982 the conversions were into 4.6 per cent special securities with no specific date for redemption and which were exclusively taken up by the Reserve Bank. As at end-March 1994, the outstanding amount of special securities held by the Reserve Bank under such conversions was ` 71,000 crore (RBI, 1994). The outstanding amount of the *ad hoc* Treasury Bills converted to special securities was ` 1.21,818 crore as at end-March 1997 (RBI, 2005a).

CHARACTERISTICS

Since mid-1950s, the *ad hocs* have acquired a different dimension. Being a banker to the Government, the RBI wants the Central Government to maintain a minimum balance in its books with the bank so that the governmental transactions were settled smoothly. A mutual agreement was, therefore, reached between the RBI and the Central Government according to which the latter should maintain ` 50 crore as a balance as on Fridays, which should be reflected in the RBI's Weekly Statement of Affairs. As a part of honouring this agreement, it was necessary to ensure that the account is replenished, whenever the actual balances drop below the ` 50 crore mark, by creation of *ad hoc* TBs in favour of the RBI, generally in multiples of ` 5 crore. Also, in case of a surplus in the account *ad hocs* would be necessary to maintain the balance, at the agreed level. This practice, which began in 1954-55 as a temporary arrangement became a regular feature over a period of time.

An important aspect of *ad hocs* is their 'funding.' 'Funding' refers to the Government's conversion of the outstanding *ad hocs* into dated securities. This was initiated in 1958-59, with the funding of ` 300 crore into 4 per cent Loan 1973, and since then it has been an annual phenomenon. In the 1970s, the magnitude of funding was around ` 100 crore annually except in the year 1970s when TBs of the face value of ` 3,500 crore were funded into special securities. However, since 1982 the quantum of funding has abruptly gone up. At end-March 1994, the outstanding amount of special securities held by the RBI under its exclusive funding operations was to the tune of ` 71,000 crore. Besides, the outstanding amounts of *ad hocs* scaled at ` 21,480 crore at end-March 1994.

Ad hocs serve two purposes, namely, they replenish Government cash balances and provide an avenue to State governments, Semi-government departments and foreign central banks for investing temporary surpluses. Thus, they aid in dampening random fluctuations in the discount rate which would result if State Governments were to compete with regular investors in TBs issued to the public.

As *ad hocs* are issued in favour of the RBI only, there is no question of selling them through tender. They are purchased by the RBI on tap, held in its Issue Department and the RBI can issue currency notes against these. In India, *ad hocs* are, in practice notionally discharged and renewed on maturity. Therefore, though technically called short-term finance, the finance raised by the Government of India through issue of *ad hocs* practically remains long-term in nature.

Ad hocs, in effect, imply automatic monetisation of Government's budget deficit. Their free expansion is potentially dangerous for sound conduct of the RBI's monetary policy. Therefore, the Union Government Budget for 1994-95 has restricted the issue of *ad hocs* to ₹ 6,000 crore for the entire 1994-95 financial year. Besides, at any point of time *ad hocs* cannot exceed ₹ 9,000 crore and remain at that level for more than 10 consecutive working days. In case of non-adherence, the RBI could take necessary action to lower the level of *ad hocs* to the maximum permissible level. Besides, over a three year period, beginning 1994-95, the issuance of *ad hocs* will be phased out. This was subsequently formalised by the Government of India through signing an MoU with the RBI.

Ad hocs and its funding, finally, raise the question of the RBI's autonomy in relation to the Central Government, particularly in the sphere of implementing the monetary policy. Towards this end, the first step which has been appropriately suggested by the RBI Governor in his M.G. Kutty Memorial Lecture, 1993 is to depart from a system in which the *ad hocs* are used by as an automatic means to finance Central Government deficits. It is hoped that after three years by when the *ad hocs* are completely phased out the Central Government will not opt for by automatic monetisation but raise entire finances directly from the market, which will indeed be by a healthy development in the Indian fiscal scenario.

ROLE OF TREASURY BILLS

Treasury Bills, the key short-term borrowing instrument of the Central Government and a convenient risk-free short-term investment avenue for the market, have served as an important tool of short-term liquidity management for the Reserve Bank. However, up to the early 1990s (especially from 1965 with a migration to the tap issuance system), the Treasury Bills could not be operated as a monetary instrument with flexible rates for liquidity management through open market operations. Market participants displayed a tendency to rediscount their initial subscriptions with the Reserve Bank which resulted in the latter passively absorbing a large volume of Treasury Bills in addition to its holding of *ad hoc* Treasury Bills issued to refurbish Government balances. The absence of a market outside the Reserve Bank for the Treasury Bills and the inflexibility in the discount rate from 1974 limited the use of Treasury Bills as a monetary tool or an efficient money market instrument. Furthermore, quite often in the 1980s, the nominal discount rates dipped below the inflation rates implying negative real interest rates.

PHASING OUT *AD HOC* TREASURY BILLS

In pursuance of the recommendations of the Chakravarty Committee, 1985 the Reserve Bank adopted a framework of monetary targetting with feedback since the mid-1980s, whereby the targetted growth of money supply was consistent with economic growth and an acceptable level of inflation. Adherence to the target implied a limit to the monetisation of Government

deficit. Despite the proactive fiscal compression and Reserve Bank's efforts in moderating money supply during the early part of the 1990s, the continuance of the ad hoc Treasury Bills implied that there could not be an immediate check on the monetised deficit. In fact, there were instances when the fiscal deficit was large during the course of the year but had moderated by the year-end. Recognising the Government and the Reserve Bank agreed in 1994 to a three-stage process of elimination of *ad hoc* Treasury Bills over a three-year period ending 1996-97.

As a result of the process of limiting the issuance of *ad hoc* Treasury Bills, the monetised deficit fell sharply during 1994-95 and for the first time in almost two decades monetary expansion during the year was not attributable to the monetisation of the fiscal deficit. The Central Government did not take recourse to *ad hoc* Treasury Bills during the greater part of the year resulting in a sharp decline in the extent of monetisation of Central Government's deficit through *ad hoc* Treasury Bills from 22.2 per cent as at end-March 1994 to 1.8 per cent as at end-March 1995. However, in the wake of a spurt in commercial credit offtake during 1995-96, despite a reduction in the Centre's fiscal deficit, the Reserve Bank had to undertake large scale devolvement of Government securities to ensure completion of the market borrowing programme, thereby increasing monetisation. The conditions normalised subsequently and the net issuances of by *ad hoc* Treasury Bills reverted to well below the ceiling by the second half of 1996-97, reflecting greater market participation.

The discontinuance of *ad hoc* Treasury Bills and its replacement by ways and means advances (WMA) in 1997-98 turned out to be available in three respects. First, the shift from the administered interest rate (4.6 per cent) to market-determined interest rates made the Government more conscious of the true costs of its borrowing programme. While this was expected to impart fiscal discipline, the move towards bond financing induced conditions for increased private capital formation. Second, it freed monetary policy from the fiscal deficit's straitjacket. Third, it allowed interest rate to reflect the opportunity cost of holding money among financial and other assets so as to improve its allocative efficiency.

CONCLUSION

Recognising the importance of the money market, the RBI has taken proactive measures to develop this segment. The institution of DFHI as a money market institution along with other steps taken to develop the created the ground for the emergence of 91 day Treasury Bills as an important market segment, abolition of the system of *ad hoc* Treasury Bills in April 1997 and introduction of 14 day intermediate Treasury Bills and auctions of Treasury Bills as a reform measure paved the way for the emergence of a risk free rate, which has become a benchmark for pricing other money market instruments. Further, it also enabled better cash management by the Government and provided alternative avenues of investments to the State Governments. Though, *ad hoc* Treasury bills were abolished, the important role it played over five decades is not minimised.

SELF ASSESSMENT QUESTIONS

- (1) What are *ad hoc* Treasury Bills.
- (2) Analyse their characteristics and their role in the market.