Public Debt in India: A Security Level Analysis*

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May 11, 2021

Abstract

We assemble a novel data-set on Indian public debt with consistently defined aggregate annual components from 1951–2018, and Centre-State security level data from 2000–2018. We quantify the contribution of inflation, real GDP growth, nominal interest rates and primary deficit/surplus towards India's debt-dynamics. We find that inflation's role in debt liquidation diminished after the adoption of flexible inflation targeting in 2014. We also find that nominal returns on the marketable and non-marketable portions of the Centre's debt account for the highest contribution towards changes in public debt. Our paper helps inform the debate on the adoption of inflation targeting in EMEs.

Keywords: Debt Decomposition, Fiscal Dominance, Indian Economy, Flexible Inflation Targeting, Public Debt in EMDEs.

JEL Codes: E62, E65, E52, G12, G28

*We are grateful to Viral Acharya, Etienne Wasmer, Jean Imbs, Gurbachan Singh, Kundan Kishor, Indira Rajaraman, Pinaki Chakraborty and seminar participants from Ashoka University (2018), the 14th Annual Conference on Economic Growth and Development at ISI Delhi (2018), Shiv Nadar University (2019), Delhi Macroeconomics Workshop at ISI Delhi (2019), and participants of the Western Economic Association International (2021) meetings. We thank Mikita Khurrana for outstanding research assistance. We also thank officials from the Department of Economic and Policy Research (DEPR), RBI, for several helpful conversations on the data. We are grateful to the PPRU (Policy and Planning Research Unit) for financial assistance related to this project. The usual disclaimer applies.

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1 INTRODUCTION

In 1951, Indian general (Centre plus State) debt was approximately 18.5% of GDP. Till 1972, general debt rose steadily to about 39%, and then fell sharply to 26% in 1975. It then stayed roughly constant as a percentage of GDP till the mid–1990s averaging 32% between 1975–1996.[1] After 1996, general debt exploded reaching 57% in 2005, a rise of 26% points in nine years. Debt-GDP in India then fell to about 50% in 2011 and then rose to 57% in 2018. As can be seen in Figure 1, between 1951–2018, Indian indebtedness peaked three times: 1972, 1988, and 2005.[2] What factors drove the large changes in public debt in India? And to what extent were these changes due to major macroeconomic reforms in the post-liberalization (post-1991) era?

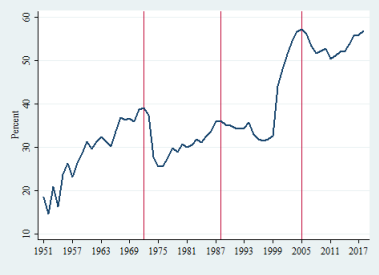

Figure 1: General Government Public Debt-GDP

This paper undertakes a debt-decomposition analysis of Indian public debt between 1959–2018. While we assemble a consistently defined annual time series of aggregate government debt between 1951–2018, we choose 1959–2018 because we have data on all four components in the government budget constraint that drive debt dynamics over this period. These components are the nominal interest rate, inflation, the real GDP growth rate, and the primary deficit/surplus.[3] Following Hall and Sargent (1997, 2011), we also undertake a debt-decomposition analysis using

[1] In Indian fiscal year (1st April to 31st March) reporting, 1975–1996 means 1974–75 to 1995–96. We retain the shorter form throughout the paper.

[2] The surge in public debt between 1951–1972 overlapped with three wars: 1962, 1965 and 1971. What is interesting about this increase is that the later peacetime surge in public debt between 1996–2005-partly due to the 5th Pay Commission-exceeded the war-time expansion in public debt in India in the sixties. Loose fiscal policy in the late eighties contributed to an increase in public debt as well. This led to a Balance of Payment (BoP) crisis in 1990 following which India undertook landmark reforms in 1991 to stabilize the economy.

[3] Like many studies, we use gross public debt in this paper as it is more prudent and portrays a more accurate picture of debt sustainability. An alternative would be to use net debt, which adjusts for both the financial and non-financial assets of the government. These are typically seen as being hard to liquidate. See Robert et al. (2017).

a newly assembled granular security level data-set on Centre-State securities between 2000–2018. Our security level data for the Centre is from 2000–2018. In order to consider general debt we collect all outstanding security level data for all Indian States from 2005–2018. In contrast to the aggregate debt data, the security level debt data is valued at market prices where the required prices are calculated from the yield to maturity data.[4] For both the Centre and States we track the securities until their maturity and consider the outstanding face value for each security as of end March every year.[5] We find from the security level analysis that for Centre securities, the maturity in years has been shrinking, so that as of 2018, most of the debt outstanding had a maturity of up to fifteen years.

The relative importance of any component in explaining debt-GDP dynamics would clearly depend on a given sub-period for which the decomposition is undertaken. We show that inflation's largest impact on eroding public debt (about 42%) happens in the sub-period 2008–2018, a period which includes the high inflation years of 2009–2014.[6] Overall, inflation's impact on the change in public debt is also fairly large (30.5%) in the 1990–1999 sub-period suggesting that when both periods are taken together, inflation is the dominant component in reducing India's public debt in the post-liberalization period. Debt liquidation therefore appears to have been helped by inflation in both the pre and post-liberalization era.[7]

Other than the four components that affect government debt, it is also important to understand how debt-GDP dynamics changed in the aftermath of major macro-economic reforms. We consider three reforms in the post-liberalization period. First, till the 1980s the interest rate structure on bank loans was largely administered. On the same loan amount, borrowers were charged different

[4]We obtain yield to maturity data from the Reserve Bank of India (RBI), HBS Table 187: Yield of SGL Transactions in Government Dated Securities for Various Maturities. We also adjust our data to accommodate the fact that particular States, like Bihar, Madhya Pradesh and Uttar Pradesh, were bifurcated. Details are available from the authors on request.

[5]This is done so that the face value outstanding is equal to the aggregate debt outstanding for that particular year. Following Hall and Sargent (2011) we then use the security level data to calculate the coupon and principal payments for the Centre and States.

[6]A $x\%$ contribution attributes $x\%$ of the total change in the debt-GDP ratio to a particular factor in a given time period.

[7]See Reinhart and Sbrancia (2015) for evidence of financial repression and debt liquidation for several advanced and emerging market economies in the post-WWII period. See Acharya (2020) for a discussion of fiscal dominance in the Indian context. See Leeper (1991) for a model of monetary-fiscal co-ordination under fiscal dominance.

rates. This distorted the structure of lending rates in the banking system. Since 1990, efforts were made to rationalize the interest rate structure to ensure better price discovery and transparency in the loan pricing system, with a near-complete de-regulation of interest rates culminating in October 1994. Since 1997, in order to encourage borrowers to switch to a loan delivery system, banks were allowed to prescribe separate prime lending rates (PLRs) for both loan and cash credit components (see Reserve Bank of India (2009)). While the dismantling of the administered interest rate occurred in a staggered manner, we take 1997 to be a year by which cumulatively, major changes had been undertaken.[8] When we slice the data around 1997, we see that the nominal interest rate's contribution to the increase in public debt rises from 25.3% between 1959–1997 to 32.3% between 1997–2018. The dismantling of administered interest rates did not contribute to a lower interest rate regime in the economy.

Second, in 2003, the government of India announced the Fiscal Responsibility and Management Act (FRBM), whose main goal was to establish financial discipline to reduce the fiscal deficit. The act announced a glide path to contain the fiscal deficit within 3-4% of GDP in the medium term, and by restricting the role of primary deficit in affecting debt-GDP dynamics.[9] In 2016, a committee under N.K. Singh was set up to suggest changes in the Act. This committee suggested using general government debt as the primary target for fiscal policy with a Centre-State government debt-GDP target of 60% to be achieved by 2023 (compromising 40% for the Centre and 20% for the States).[10] We show that the implementation of the FRBM in 2003 had a salubrious effect on India's debt trajectory: the primary deficit's contribution to the change in the debt-GDP ratio during 1991–2003 was 20.9% compared to the period after the implementation of the act (2003–2018) where it fell to 10.8%. Seen from a longer time perspective (from 1980 onwards) however,

[8]The first "test" of these reforms came in the early 2000s when large capital flows and a number of monetary easing measures by the RBI resulted in abundant liquidity in 2001–2004. However, the reduction in rates were generally not reflected in the lending rates across all banks, and for many banks, the actual lending rates were much higher than those prescribed by their PLRs (Reserve Bank of India, 2009, p.8). Monetary transmission was therefore limited leading to high interest rates in the economy even after the dismantling of administered interest rates. This led to interest rates having a higher contribution to changes in the debt-GDP ratio compared to the preceding period.

[9]In 2013, the government introduced the concept of an effective revenue deficit, which adjusted the revenue deficit for grants to states for the creation of capital assets.

[10]See FRBM Review Committee (2017). We note that the movement from fiscal deficit targets to debt-targets recommended by the N.K. Singh Report highlights the salience of this paper.

the contribution of the primary deficit in the rise of public debt-GDP in India fell till about 2008, but began to rise again in the 2008–2018 period suggesting a mixed record of the 2003 FRBM Act in the post-liberalization period.

Third, India also adopted flexible inflation targeting (FIT) in 2016, ensuring that the role played by inflation in affecting public debt also came down. The full institutional architecture for inflation targeting in India was laid out in a monetary policy framework agreement (MPFA) between the RBI and Government of India in 2015. This framework set a medium term inflation target of 4 plus/minus 2 percent. However, starting in 2014, a bi-monthly policy review cycle was implemented with bi-annual (October and April) monetary policy reports (MPRs) starting in September 2014. We therefore consider the de-facto date for the adoption of inflation targeting to be April 2014 (see Ahmed and Ghate (2020)).[11] We show that over the roughly sixty year period that our sample covers, inflation's contribution to lowering public debt has become larger over time, although it has begun to diminish after the de-facto adoption of FIT in India in 2014.

Our main insights using the Centre-State security level dataset are also informative.[12] From the security level analysis we show that during the entire period of 2005–2018, the change in debt-GDP is about 7%. Of this 7% change, the biggest contributing factor is the nominal returns on the marketable portion of the debt, at about 40%. Even the nominal return on the non-marketable portion is substantial at about 25%. This suggests that the nominal interest rate is the predominant component driving the change in the debt-GDP ratio during this period.

We also use both aggregate and security level decompositions to assess the standard debt sustainability criterion that compares the nominal interest rate, r, with the nominal GDP growth rate, g. We find that with both the aggregate debt and security level data, $r < g$, for the duration for which the decomposition is undertaken. This suggests that while Indian public debt has been sustainable historically, the role of inflation in driving debt liquidation is an important feature. The

[11] This gives us a slightly longer phase for the presence of FIT in our sample (2014–2018).

[12] It should be pointed out that the debt decomposition analysis using aggregate debt suffers from a drawback. This is because any analysis with aggregate debt data typically leaves residuals that are unaccounted for (Buiter et al., 1985). We show that when we undertake the decomposition analysis with the security level data, the residuals are sharply reduced lending more precision to the accounting exercise.

large contribution of nominal returns, however, poses a challenge to debt management. We also find that the level of volatility in variables that are typically associated with fiscal dominance: household savings, the real effective exchange rate (REER), and uncertainty fell in the post-FIT period (2014–2018).[13]

Our paper builds on the voluminous literature on debt-decomposition analyses in the Indian context in three major ways.[14] First we extend this literature by assembling a novel Centre-State security level dataset. We then undertake a debt-decomposition analysis following the methodology in Hall and Sargent (1997, 2011). We believe this is the first such exercise to do so in the Indian context. Second, our aggregate analysis builds a consistent historical time series of general government debt from 1951 collating multiple sources spanning several publications and data sources from the RBI and the Ministry of Finance (MoF). Unlike Rangarajan and Srivastava (2003), our decomposition exercise also covers the inflation targeting period which we define as having started in 2014. Finally, because macroeconomic reforms can influence public debt dynamics, we examine how key macroeconomic reforms, such as flexible inflation targeting, changed the relative importance of the components driving public debt dynamics in the period after these reforms were implemented.

2 Stylized Facts

Government liabilities in India include debt issued against the Consolidated Fund of India (technically, defined as Public Debt) and liabilities in the Public Account (Other Liabilities). Thus total liabilities is a sum of public debt and other liabilities. As of end-March 2018, while general government public debt (Centre and States) as a share of GDP was 57%, general government total liabilities (the number commonly reported in the media) was 73%.[15] The time series plot of

[13]The uncertainty index we use in the paper follows Baker et al. (2016) which is obtained from FRED (2020a). In future work we plan a more detailed analysis of the link between the form of debt liquidation and its associated volatility in the economy.

[14]The list of papers that analyze public debt in the Indian context is too long to list here. For important contributions, however, see Buiter and Patel (1992) and Rangarajan and Srivastava (2003)

[15]General government debt includes debt for Centre and States. General government total liabilities include, general government debt and other liabilities of the Centre and States.

general government public debt (Centre and States) and general government total liabilities as a percentage of GDP in Figure 2 shows an upward trend in both specially post-1980s with a stark rise in both in the run-up to the enactment of FRBM in 2003.[16] Liabilities under the public account (Other Liabilities) of both Centre and State taken together currently account for about 14% of GDP with that of the Centre and State being about 10% and 5%, respectively. Public debt on the other hand currently accounts for about 57% of GDP.

Figure 2 suggests that in the decade after India's 1991 liberalization, the general debt to GDP ratio in India stayed constant till 2000 averaging 34%, not very different from the debt-GDP average (30%) between 1950–1990. In contrast, between 1996–2005, there is a sharp increase in the debt-GDP ratio rising to 57% in 2005, a rise commonly attributed to the Centre and State implementations of the 5th Pay Commission in 1995.[17] Post 2003, both because of the FRBM Act of 2003 and the high growth years that ensued between 2003–2009, the debt-GDP ratio declines marginally to 52% in 2009. While the share of the general debt-GDP from 2004–2018 has been relatively constant and has averaged 54%, there has been a larger decline in the total liabilities owing to a decline in the proportion of liabilities in the public account. Liabilities in the public account as a share of GDP declined from about 28% in 2004 to about 14% in 2009. Since the Great Financial Crisis, between 2009–2018, the general debt-GDP ratio has averaged 53%.

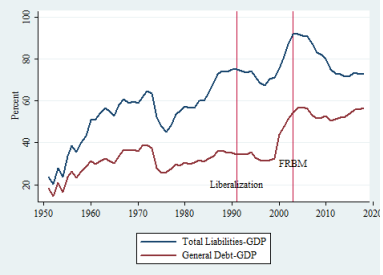

Figure 2: General Government Public Debt-GDP and General Government Total Liabilities-GDP

Public Debt is broadly divided into internal and external debt. The latter is debt raised from

[16] For our calculations of general debt-GDP we used external debt at historical prices. This is due to the lack of data on external debt at current prices. Our calculations of general government public debt to GDP therefore differs from that in Ministry of Finance (2018) for overlapping years. Specifically, for overlapping years (2009–2017) our general government debt-GDP is on an average lower than that in the Status Paper by about 2%.

[17] See Mohanty and Panda (2019).

outside of the territory of India and is predominantly borrowed in three currencies, SDR, USD and Yen (about 96% of total external debt) and 4% is borrowed in Euros. States in India cannot issue external debt and therefore the distinction of debt into internal and external is only relevant for the Centre. External debt as of end-March 2018 was 6% of total Centre liabilities and was about 1.5% as share of GDP. Internal debt in 2018 stood at 78% of total Central liabilities and about 38% of GDP.

Internal or domestic debt for both the Centre and States is further divided into marketable and non-marketable debt as shown in Figure 3.[18] The marketable debt for the Centre consists of dated securities and treasury bills and that for the States consists of market loans (State Development Loans or SDLs in short) issued by various States.[19] Non-Marketable debt for the Centre consists of National Small Savings Fund (NSSF), special securities issued to international financial institutions, POLIF and RPOLIF, compensation and other bonds, and 14-day intermediate treasury bills issued to State governments and some other central banks.[20] As can be seen in Figure 3, the trajectory of the marketable share of general public debt illustrates a distinct U-shaped pattern since 1951. The marketable share of public debt, around 89% in 1951, declines to roughly 34% in 1991, and then begins to rise again, to approximately, 80% in 2018. The higher proportion of marketable debt in total debt suggests higher exposure to market forces on public debt management in India over the years.

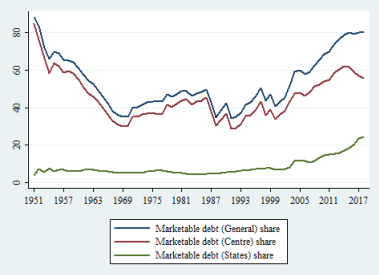

Figure 3: Share of Marketable debt to Total Debt

[18] Internal debt constituted 97% of Centre and States' public debt as of 2018.

[19] From our State security level data we find that these are typically auctioned in 10-year, 15-years, and 30-years maturity.

[20] POLIF is Post Office Life Insurance Fund (POLIF) and RPOLIF is Rural Post Office Life Insurance Fund.

[21] Note: Percentages are calculated from average of the variables from 2000–2018.

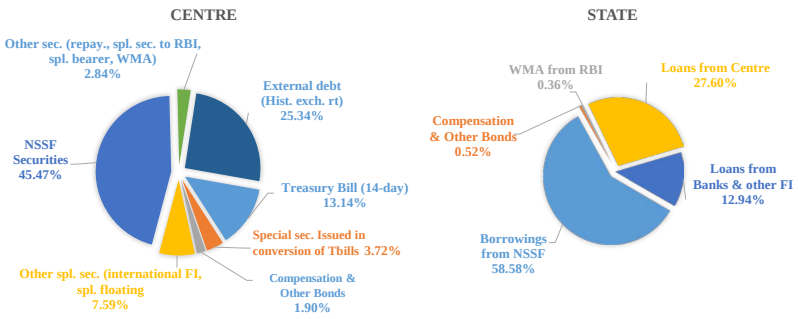

Figure 4: Share of Components in Non-Marketable debt of Centre and States (2000–2018)[21]

An important feature of India's public debt is the role played by the National Small Savings Fund (NSSF). When considering the Centre's total liabilities i.e., public debt and other liabilities, the NSSF enters both (Ministry of Finance, 2019). Specifically, out of the total NSSF corpus, special securities were first issued by the Centre in 1999–2000 and thus featured as an item listed as 'NSSF securities' under the non-marketable portion of the debt. As can be seen from Figure 4, since 2000, NSSF securities have been the main driver of the non-marketable debt of the Centre contributing on an average about 46% to non-marketable debt from 2000–2018 with the highest share being that for 2004 at about 72%.[22] However, the share of the NSSF in the total debt of Centre for the same period averaged 12%, recording a maximum value of 24% in the year 2000. A similar result is observed for the States so that 'NSSF borrowings' (an item listed under non-marketable debt for the States) was also the main driver, and averaged about 59% of the non-marketable debt of States during the same period with the share reaching 68.5% in 2011. In terms of the share of NSSF borrowing in total State debt the average was about 29% and the highest was recorded in 2007 when it was about 47%. Figure 5 suggests that the rise in the debt-GDP around 2000 is both a Centre and State phenomenon.[23]

[22]Prior to 2000 the data reports zero issuance of NSSF securities. This is because a change in the system of accounting for loans to States and UTs were brought about in the budget of 1999–2000. As per the new accounting system small savings collections were to be credited to the "National Small Savings Fund" (NSSF) and all withdrawals by the depositors would be made out of the accumulation of the fund. The balance amount in the fund would then be invested in the Centre and State government securities. Thus, all investments in the Central securities would be reckoned as part of the internal debt of the Centre from 1999–2000 onwards and the total small savings collection would not appear as part of the Centre's fiscal deficit.

[23]Public finances, between 1996–2005, witnessed a deterioration reflecting a variety of factors such as the decline in tax revenue because of the cyclical downturn in economic activity, and the effects of the 5th Pay Commission. Central revenue expenditure increased from 11.8% of GDP in 1996 to 13.2% in 2001. The combined (Centre plus State) fiscal

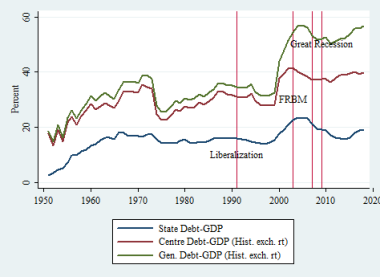

Figure 5: Debt-GDP:General, Centre & State

Security level data lends itself to analysis pertaining to the market value of debt and the associated maturity structure. We therefore assemble a novel Centre and State security-level data-set from 2005–2018.[24] Using this data, Figure 6 shows the nominal payouts as a share of GDP by year and maturity for Centre securities from 2000–2018.[25] Figure 6 shows that since 2010 there has been a gradual decline in the maturity of the debt raised by the Centre. In 2018, the highest maturity for nominal payouts as a share of GDP is 15 years. Thus, for Centre securities, most of the debt is below 15 years.

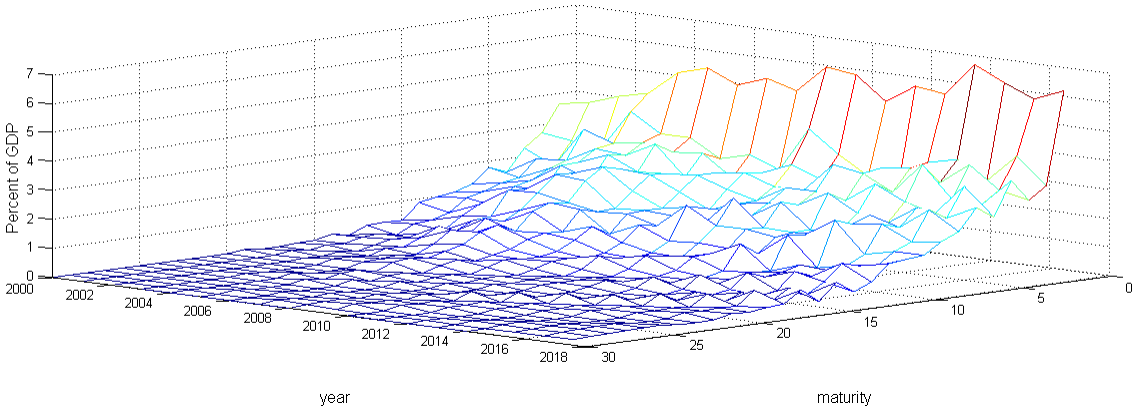

Figure 6: Nominal payouts as a share of GDP by year and maturity of debt for Centre[26]

In terms of the ownership pattern of dated securities, as of end March 2019 (see Ministry of Finance (2019)), commercial banks are the dominant holders (40.3%) followed by insurance

deficit in 2001–02 (about 10% of GDP) was higher than that in 1990–1991 (about 9% of GDP). See Mohan (2007).

[24]Data for State securities are from the Statement on State Government Market Loans from the 'State Finances: A Study of Budgets' for various years.

[25]Nominal payouts are calculated from security level data of the Centre using the price data calculated from yield to maturity and face value of debt for maturities 1 year to 30 years. Details of the method is discussed in Section 4.1.

[26]We generate Figures 6, 9, and Tables 1, 4, 5 using MATLAB R2019b.

companies (24.3%) and provident funds (5.3%).

3 Debt Decomposition: Aggregate debt

3.1 Methodology

We first undertake a debt-decomposition of Indian public debt to account for the factors affecting the debt-GDP ratio over a long time series, 1959–2018. We consider debt raised by the Centre and States. From the period-by-period government budget constraint (GBC), the decomposition accounts for the factors that affect the difference in the debt-GDP ratio between any two time periods. As mentioned in the Introduction, our paper considers a longer time series than most studies. We also undertake the debt-decomposition exercise around major macroeconomic reforms in the post-liberalization era, allowing us to assess the impact of these reforms on the evolving debt-dynamics. Consider the following GBC:

$$B_t = (1 + r_{t-1})B_{t-1} + G_t - T_t \tag{1}$$

where B_t is the debt in rupees at the end of period t and B_{t-1} is the debt with which government enters period t. The nominal interest rate on the debt is denoted by r_{t-1}, with G_t and T_t denoting the government spending and tax revenue during period t, respectively. If Def_t denotes the primary deficit (i.e., $D_t = G_t - T_t$) then equation (1) can be re-written as:

$$B_t = (1 + r_{t-1})B_{t-1} + \text{Def}_t \tag{2}$$

Let P_t and Y_t denotes the price-level and the output (RGDP) in time t. Then the above equation can be further written as:

$$\frac{B_t}{P_t Y_t} = (1 + r_{t-1})\frac{B_{t-1}}{P_{t-1}Y_{t-1}}\frac{P_{t-1}}{P_t}\frac{Y_{t-1}}{Y_t} + \frac{\text{Def}_t}{P_t Y_t} \tag{3}$$

Letting b_t denote the real debt-GDP ratio at time period t, π_t the gross inflation rate, g_t the real growth rate of output, and def_t the real primary deficit, then

$$b_t = \frac{(1 + r_{t-1})}{(1 + \pi_t)(1 + g_t)} b_{t-1} + \text{def}_t$$

Using standard approximations, we can write the above equation as

$$b_t = (1 + r_{t-1} - \pi_t - g_t) b_{t-1} + \text{def}_t \tag{4}$$

Equation (4) can be used to express the difference between debt-GDP between periods t and $t-1$. This is given in equation (5) and suggests that the change in the debt-GDP ratio between two consecutive periods is positively affected by the nominal interest rate and the primary deficit, and negatively by inflation and the real growth rate, i.e.,

$$b_t - b_{t-1} = (r_{t-1} - \pi_t - g_t) b_{t-1} + \text{def}_t \tag{5}$$

If we iterate backward on equation (5) to account for the change in debt-GDP ratio between any two arbitrary time periods (say t and τ) we obtain,

$$b_t - b_{t-\tau} = \sum_{i=0}^{\tau-1} \left[(r_{t-1-i} - \pi_{t-i} - g_{t-i}) b_{t-1-i} + \text{def}_{t-i} \right]$$

which can be written as

$$b_t - b_{t-\tau} = \sum_{i=0}^{\tau-1} \Big[\underbrace{(r_{t-1-i} b_{t-1-i})}_{\text{Nominal return}} - \underbrace{(\pi_{t-i} b_{t-1-i})}_{\text{Inflation}} - \underbrace{(g_{t-i} b_{t-1-i})}_{\text{Growth rate}} + \underbrace{\text{def}_{t-i}}_{\text{Primary deficit/surplus}} \Big] \tag{6}$$

Equation (6) shows that there are four components affecting the debt-GDP ratio difference between periods t and τ: namely, the nominal return, inflation, the real GDP growth rate and the primary deficit/surplus. We can now use our long time series data on the interest rate, inflation, growth

rate and primary deficit/surplus to exploit equation (6) to calculate these different components. We begin by undertaking the decomposition for aggregate debt data available for general debt (Centre and States).[27]

3.2 Decomposition Results

Table 1 represents the debt-decomposition of general debt-GDP for India 1959–2018 using equation (6) as the basis for our analysis. Table 1 also reports the decomposition around 1) the removal of administered interest rates by 1997, 2) the implementation of the FRBM Act in 2003, and 3) India's de-facto adoption of inflation targeting in 2014.

Although informative, it should be pointed out that the debt decomposition using aggregate debt suffers from a drawback. This is because any analysis with aggregate debt data typically leaves residuals that are unaccounted for.[28]Total debt is a combination of debt with varying maturity and each maturity has a corresponding interest rate. One reason such residuals occur is due to the fact that we use an interest rate that is only representative of the total debt, i.e., an effective interest rate. This obscures knowing what the "true" interest rate is leading to the possibility of large residuals. Measurement errors in growth numbers as well as the deficit figures also add to the residual component.[29]

There are several takeaways from the debt-decomposition exercise, as in numerically in Table 1, and it's visual counterpart, Figure 8. Figure 7 uses an annual decomposition to plot the evolution of each component from 1959–2008. As can be seen from Table 1, apart from the first sub-period, 1959–1963, and the last sub-period, 2008–2018, the remaining sub-periods have been divided so that they have a duration of nine years. Looking at the decomposition from 1963 onwards, the largest increase in public debt happens in the 1999–2008 sub-period, when public debt

[27]General debt is defined as Centre debt + States debt - States investment in Treasury Bills of Centre - Loans from Centre to States. See Appendix 7.1 for details.

[28]Table 1 reports the column "Residuals" that is calculated by taking the difference between the LHS and RHS of the debt-decomposition equation. The presence of residuals is common in such analysis (even in advanced economies) as pointed out in Buiter et al. (1985).

[29]In the next section we undertake the same decomposition using security level data whereby the interest rate used in the calculations are the rates that correspond to a particular debt maturity. We find that the unexplained proportions are substantially reduced.

Table 1: Debt Decomposition (General Debt): 1959-2018

Period		Debt-GDP (LHS)			Components (RHS)					RHS
End	**Start**	**Start**	**End**	**Change**	**Nominal interest**	**Inflation**	**Growth**	**Deficit**	**Residual**	**Total**
1959	1963	28.5	32.4	3.9	0.8	-3.5	-5.0	3.6	7.9	3.9
1963	1972	32.4	39.0	6.6	2.2	-20.4	-12.5	7.1	30.1	6.6
1972	1981	39.0	30.0	-9.1	3.2	-24.6	-11.3	12.3	11.4	-9.0
1981	1990	30.0	35.0	5.1	7.5	-26.5	-15.1	27.3	11.8	5.1
1990	1999	35.0	32.5	-2.5	15.4	-30.5	-14.5	18.4	8.7	-2.5
1999	2008	32.5	51.7	19.2	16.2	-20.6	-33.2	7.9	48.9	19.2
2008	2018	51.7	56.7	5.1	12.2	-41.8	-24.3	9.4	49.6	5.1
Administered Interest Rate										
1959	1997	28.5	31.4	2.9	25.3	-99.0	-56.9	63.9	69.6	0.0
1997	2018	31.4	56.7	25.3	32.3	-68.8	-59.0	22.1	98.8	0.3
FRBM										
1991	2003	34.4	54.3	19.9	20.8	-34.6	-19.5	20.9	32.3	0.2
2003	2018	54.3	56.7	2.5	21.6	-55.1	-50.0	10.8	75.1	0.0
Inflation Targeting										
2009	2014	52.2	52.2	0.1	6.5	-26.9	-11.0	5.6	25.8	0.0
2014	2018	52.2	56.7	4.5	4.0	-10.6	-11.1	2.2	20.0	0.0

Notes:
[1.] LHS and RHS refers to those of equation 6.
[2.] The entries are all in percent.
[3.] The negative signs are in line with the debt decomposition equation 6. Thus, entries in columns 'Inflation' and 'Growth' enter as negative numbers representing the fact that inflation and growth rate help reduce the debt-GDP ratio. A negative entry in column 'Deficit' implies a surplus.
[4.] For the debt decomposition exercise with aggregate debt we use an "effective" interest rate that we calculate from interest payments data. The available data for interest payments pertains to total government liabilities and not exclusively related to public debt and therefore we make the following adjustment:

$$\text{Effective interest rate} = (\text{Interest payments}) * \frac{(\text{Other liabilities of Centre and States})}{\text{General debt}}$$

where, by "other liabilities" we mean Other Liabilities on the Public Account of the Centre and States, as the case may be.
[5.] 'Residual' is calculated by taking the difference between column 'Change' and the sum of columns 'Nominal interest', 'Inflation', 'Growth' and 'Deficit'.

explodes from 33% to 52%, a roughly 19% increase. This increase is primarily due to the 1995 5th Pay Commission awards which were implemented in staggered fashion by the States (Kaur et al., 2018). Throughout all sub-periods, inflation and growth both have a downward influence on the change in debt-GDP, while the nominal interest rate and the primary deficit exert an upward influence. This is confirmed by Figure 7 which plots each component over the sub-periods defined in Table 1, and Figure 8 which plots each of the components annually between 1959–2018.

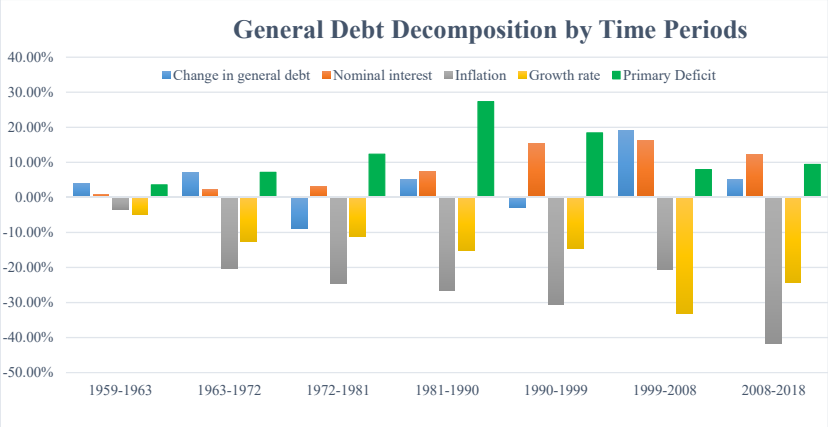

Figure 7: Bar plot of Decomposition for all periods

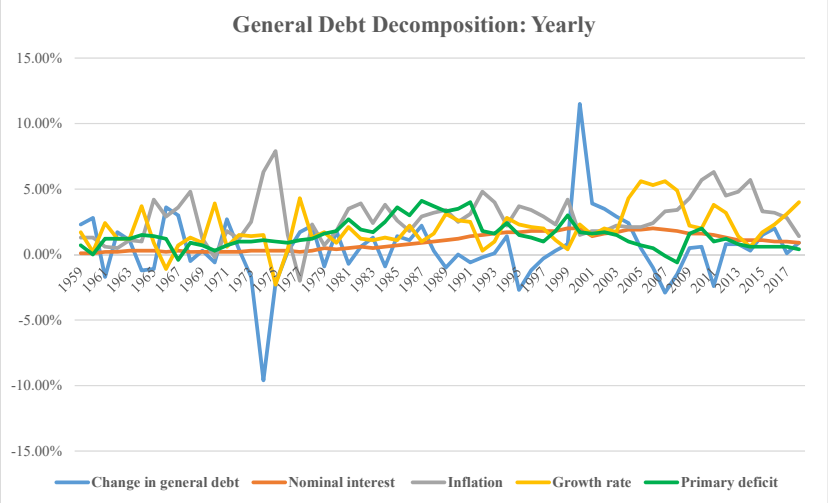

Figure 8: Time Series of Decomposition for all years

Inflation's largest impact on eroding public debt (41.8%) happens in the 2008–2018 period because of the high inflation rates in India during the 2009–2014 sub-period averaging about 10%.

Inflation's impact on the change in public debt is also fairly large (30.5%) in the 1990–1999 sub-period. Figure 7 shows that over the sixty year period that our sample covers, inflation's contribution to lowering public debt (the grey bar) has successively become larger across time periods suggesting debt liquidation. GDP growth exerts a strong downward influence on public debt in both the 1999–2008 and 2008–2018 periods because of the high growth rates in India during the decade of 2003–2016 (notwithstanding the slump in growth to about 4% in 2009–2010 after the Great Financial Crisis (GFC)). The primary deficit's largest impact on the debt-GDP ratio happens in the 1981–1990 period. It is well known that towards the end of the decade of the eighties, fiscal policy was loose. While this had raised growth, it also contributed to the BoP crisis of 1991 (Acharyya, 2012).

As mentioned in section 1 the year 1997 saw the culmination of a series of steps taken to dismantle administered interest rates. When we slice the data around 1997, we see that nominal interest rate's contribution to the increase in public debt rises from 25.3% between 1959–1997 to 32.3% between 1997–2018. The dismantling of administered interest rates, ceteris paribus, should have contributed to a lower interest rate regime in the economy. This is however not borne out in Table 1 because of the lack of transmission between interest rates in financial markets and overall credit market rates. When we perform a similar exercise around the implementation of the FRBM Act (2003), Table 1 shows that the primary deficit's contribution to the change in the debt-GDP ratio during 1991–2003 is 20.9% compared to the period after the implementation of the Act (2003–2018) where it falls to 10.8%. The deficit's contribution to public debt during the 2013–2018 is also lower than any other component during the same period. This suggests some success by the FRBM Act to curtail the deficit's contribution to public debt after 2003. From a longer time perspective (post 1980) however, Figure 7 shows that the contribution of the primary deficit (the green bar) to the rise of public debt-GDP in India fell till about 2008, but began to rise again in the 2008–2018 period. In 2009, the Central government's fiscal deficit was 6% of GDP, and most fiscal indicators deteriorated subsequently (Buiter and Patel, 2012). India adopted flexible inflation targeting de-facto in 2014 and de-jure in 2016, which led to a decline in inflation

after 2014. The decomposition would predict that declining inflation in India after 2014 should lead to a lower contribution of inflation to the change in debt-GDP over 2014–2018. This is indeed borne out in Table 1 where the contribution of inflation to the change in debt-GDP ratio falls from 26.9% in 2009–2014 to 10.6% in 2014–2018.

4 Debt Decomposition: Security Level

4.1 Methodology

Following (Hall and Sargent, 1997, 2011), we now undertake the decomposition of debt-GDP ratio using security level data. There are certain advantages of undertaking a security level decomposition. First, it sheds light on the maturity structure of debt and the effect it has on the interest rate component of public debt. Second, it helps delineate the four above-mentioned factors on the marketable and non-marketable portion of the debt. Third, real returns on securities of different maturities can be easily calculated. Typically, the government interest cost consists of coupon payments that is due to debt holders. However, over time there are also capital gains/losses on securities held. Thus, other than the coupon payments one must take into account the capital gain/loss on the holding of such securities. This typically applies to the cases when the securities are longer in maturity (not just a one-period security). The Hall-Sargent way of looking at the security level data helps to accommodate the capital gain/loss that emerge due to the maturity structure of the debt. To see how this can be achieved consider the following variables.[30]

Let s^t_{t+j} be the number of time $t+j$ rupees that the government has at time t promised to pay; q^t_{t+j} is the number of time t rupees it takes to buy a rupee at time $t+j$ such that:

$$q^t_{t+j} = \frac{1}{(1+\rho_{jt})^j}$$

[30]From the term structure of interest rate each security can be viewed as a zero-coupon bond. The Hall-Sargent methodology involves viewing the coupon bond as a bundle of pure discount bonds. Unbundling the coupon bond into the constituent pure discount bonds and then valuing these components and finally, adding up the values of the components giving us the value of the bundle.

where ρ^j_{jt} is the time t yield to maturity on securities with j periods to maturity. Also, let p_t be the price level in base year rupees and ν_t be the value of the currency measured in goods per rupee so that $\nu_t = \frac{1}{p_t}$.

The aggregate government debt is a sum of securities of different maturities so that in terms of the securities of different maturities equation (1) can be written as:

$$\frac{\tilde{B}_t}{Y_t} = \sum_{j=1}^{n} \tilde{r}_{t-1} \frac{\tilde{B}^j_{t-1}}{Y_{t-1}} - (\pi_t + g_t)\frac{\tilde{B}^j_{t-1}}{Y_{t-1}} + G_t - T_t \tag{7}$$

Note that the aggregate government debt is a sum of both marketable and non-marketable debt. Accordingly, the above equation would be modified to the following:

$$\frac{\tilde{B}^m_t + \tilde{B}^{nm}_t}{Y_t} = \sum_{j=1}^{n} \tilde{r}^j_{m,t-1} \frac{\tilde{B}^{m,j}_{t-1}}{Y_{t-1}} + \tilde{r}^j_{nm,t-1} \frac{\tilde{B}^{nm,j}_{t-1}}{Y_{t-1}} - (\pi_t + g_t)\left(\frac{\tilde{B}^{m,j}_{t-1} + \tilde{B}^{nm,j}_{t-1}}{Y_{t-1}}\right) + G_t - T_t \tag{8}$$

where, $\tilde{B}^m_t, \tilde{B}^{nm}_t$ represents marketable debt and non-marketable debt, respectively, such that $\tilde{B}^m_t = \sum_{j=1}^{n} \tilde{B}^{m,j}_t$, and $\tilde{B}^{nm}_t = \sum_{j=1}^{n} \tilde{B}^{nm,j}_t$ $j = 1, 2, ..., n$. The interest rates $\tilde{r}^j_{m,t-1}, \tilde{r}^j_{nm,t-1}$ denotes the interest on the marketable and non-marketable portion of the debt, respectively, corresponding to the security of maturity j.

Using the above defined variables equation (6) can be re-written as:

$$\frac{\sum_{j=1}^{n} \nu_t q^t_{t+j} s^t_{t+j}}{Y_t} = \sum_{j=1}^{n} \left(\frac{\nu_t}{\nu_{t-1}} \frac{q^t_{t+j-1}}{q^{t-1}_{t+j-1}} \frac{Y_{t-1}}{Y_t} - 1\right) \frac{\nu_{t-1} q^{t-1}_{t+j-1} s^{t-1}_{t+j-1}}{Y_{t-1}} +$$

$$\frac{\sum_{j=1}^{n} \nu_{t-1} q^{t-1}_{t+j-1} s^{t-1}_{t+j-1}}{Y_{t-1}} + \frac{def_t}{Y_t} \tag{9}$$

Thus,

$$\nu_t q^t_{t+j} s^t_{t+j} = \tilde{B}^j_t \left(\frac{\nu_t}{\nu_{t-1}} \frac{q^t_{t+j-1}}{q^{t-1}_{t+j-1}} \frac{Y_{t-1}}{Y_t}\right) \approx \tilde{r}^j_{t-1} - \pi_t - g_t$$

4.2 Decomposition Results

We analyze the debt decomposition from the security level data for Centre securities, States' securities and both Centre and States together. The results for the Centre and Centre and States taken together are shown in Tables 2, and 4.[31] We also divide the components as per the maturity of debt and the results of that analyses are shown in Tables 3, and 5. Due to reasons pertaining to data availability debt decomposition for Centre securities start from 2000, that of the States' and general debt begin from 2005. We note that the security level decomposition helps reduce the residuals substantially suggesting a more accurate approach to track public debt dynamics.

Between 2000 and 2018 the change in Centre's debt-GDP was about 19% as shown in Table 2. Of this 19% change about 46% was due to nominal returns on the marketable portion of Centre's debt and about 28% was due to the non-marketable portion of the debt. Taken together the nominal return on marketable and non-marketable debt is higher than the other components between 2000–2018. The two other components that are important in affecting the change in debt-GDP are inflation at about 35% and growth at 31%. However, considering the fact that India adopted Inflation Targeting (IT) de-facto in 2014, the impact of inflation on the debt-GDP ratio is expected to be low in the years following IT. This is borne out in Table 2 where the contribution of inflation falls from 15.6% to 6.6% in the marketable portion of the Centre's debt. As in the aggregate analysis in Table 1 the primary deficit's contribution to change in the debt-GDP ratio falls markedly in 2014–2018 compared to 2009–2014 because of the renewed focus in 2014 on meeting the FRBM guidelines.

Dividing the whole period (2000–2018) into smaller sub-periods helps to understand the contribution of the different components over time and across important episodes. The first sub-period 2000–2005 highlights the explosive increase in public debt that came with the implementation of the 5th Pay Commission. The next sub-period 2005–2009 roughly captures the decline in public debt (-0.8%) due to the high growth phase of the Indian economy from 2003–2009. This was fol-

[31] The results of the debt decomposition exclusively for the States are qualitatively similar to those for the Centre and States taken together. Hence we do not present the relevant Tables for the States here but they are available upon request.

lowed by the high inflationary phase when inflation clearly stands out as the main driver leading to lowering of the change in debt-GDP (0.1%) and also leading to negative real returns. During this period the real returns on the securities of maturity 1 year, 2-10 years and 10+ years are all negative at -1.6%, -3.4%, and -1.4%, respectively, as shown in Table 3. After the adoption of inflation targeting in 2014 the rise in public debt is about 3.7% reflecting a period when the decline in inflation contributed to an uptick in public debt.[32] The variability in nominal returns on various tranches of the marketable portion of Centre's debt (Figure 9) shows that the return on the 2-10 years maturity varied the most followed by the 10+ years tranche. This is partly due to the fact that much of the Centre's marketable debt has a maturity between 2-10 years as can be seen from Figure 6. In the final period, 2014–2018, real interest rates become positive with a flip in the contribution of real returns (from -5.8% to 6.6%) to the rise in debt-GDP of about 4%. This happened because of the move to a prolonged period of positive real interest rates that accompanied the transition to IT in India.

The decomposition results for Centre and States' securities taken together between 2005–2018 are reported in Table 4 and that with maturity breakouts are shown in Table 5.[33] During the entire period 2005–2018 the change in debt-GDP was about 7%. Of this 7% by far the biggest contributing factor was the nominal returns on the marketable portion of the debt at about 40%. Even the nominal return on the non-marketable portion was substantial at about 25%. This is not implausible given that this was also the period when the Centre was on a path to reducing its support in the form of loans to the States and the latter therefore started borrowing from the market. The next important component that positively affected the change in debt-GDP ratio was the primary deficit at about 23%. The other two components that not only helped reduce the debt-GDP ratio but also played important roles were inflation and growth rate at 37% and 29%, respectively. This result is expected given the fact that the economy experienced both high inflation (2009–2014) and high growth (2003–2009).

[32]The nominal return for non-marketable debt is calculated as a residual component following Hall and Sargent (2011).

[33]Reliable State securities' data was only available from 2004 onwards hence the decomposition results begin from 2005 and not 2000 like in the case of Centre securities.

The high growth years is captured in the sub-period 2005–2009 whereby we observe the debt-GDP ratio decreasing by 0.7% brought about to a big extent by the high GDP growth rate. Although the nominal returns on both marketable and non-marketable debt were high (about 23% taken together), the high growth rate (at about 16%) helped bring down the debt-GDP ratio in the presence of a weak response from the primary deficit at about 1.8%. The contribution of the primary deficit was especially low due to the fact that the FRBM Act was passed in 2003 and it required the Centre and States to restrict their deficits to about 3% of GDP over time.

In the next period, 2009–2014 the debt-GDP ratio falls by about 0.6%. These were the high inflationary years and the decomposition exercise also reflects this fact whereby, we find inflation playing the most important role in affecting the debt at about 25% in all. The high inflation in this period led to negative real interest rates which in turn contributed negatively to (about 7%) the change in the debt-GDP ratio. From Table 5 it is observed that the negative real returns for all three maturity tranches led to a downward change in the debt-GDP ratio. With a moderate growth rate of about 4.25% (average growth rate between 2009–2014) there could not have been a significant role played by growth rate. Also, to be noted during this period is the fact that the primary deficit was quite high (compared to the previous sub-period) contributing about 14%. As mentioned before, the fiscal deficit for the Centre rose from 2% before the Great Financial Crisis to about 6% in 2009. With non-negligible nominal returns during this period, it does not come as a surprise that debt-GDP did not fall by more than we observe.

The last period marks the adoption of Inflation Targeting by India and as a result the impact of inflation on bringing down the debt-GDP ratio was low. Also, the growth rate was high during this period. Despite the helpful contribution from inflation and growth, the contributions from the primary deficit (about 8%) and nominal returns (about 22% in all), the latter led to an eventual rise in the debt-GDP ratio of about 8%.

Table 2: Security Level Debt Decomposition for Centre Securities

		Period				
Start End		2000-2018	2000-2005	2005-2009	2009-2014	2014-2018
Debt-GDP						
	Start	19.3	19.3	35	34.2	34.3
	End	38	35	34.2	34.3	38
	Change	18.7	15.7	-0.8	0.1	3.7
Marketable debt						
	Nominal return	45.8	14.8	8.2	9.2	13.5
	Inflation	-34.7	-5.5	-7.1	-15.6	-6.6
	Real return	10.9	9	1	-5.8	6.6
	Growth rate	-31.4	-8.8	-9.4	-6.3	-6.9
Non-marketable debt						
	Nominal return	27.7	13	7.3	4	3.4
	Inflation	-4.2	-0.4	-1	-2.1	-0.7
	Growth rate	-3.8	-0.8	-1.3	-0.9	-0.8
Primary Deficit/GDP		17.8	3.3	1.9	10.5	2

Notes:
[1.] Entries are all in percent.
[2.] For each column the entry for Change in Debt-GDP is approximately equal to the sum of rows 6, 7, 9, 11-14 following equation (8). The RHS total for 2000–2018, 2000–2005, 2005–2009, 2009–2014, 2014–2018 were 17.2, 15.7, -1.5, -1.1, 4.0, respectively. Therefore, the residuals are, 1.5, 0, 0.7, 1, 0.3 for 2000–2018, 2000–2005, 2005–2009, 2009–2014, 2014–2018, respectively.
[3.] Real return for marketable debt is calculated by adding inflation component with the nominal return component.

Figure 9: Nominal returns by maturity tranches of the Centre

Table 3: Security Level Debt Decomposition for Centre Securities by Maturity

			Period				
Start End			2000-2018	2000-2005	2005-2009	2009-2014	2014-2018
Debt-GDP							
	Start		19.3	19.3	35	34.2	34.3
	End		38	35	34.2	34.3	38
	Change		18.7	15.7	-0.8	0.1	3.7
Marketable debt							
	Nominal return		45.8	14.8	8.2	9.2	13.5
		1-2 years	11.7	2.9	2.6	3.1	3.1
		2-10 years	24.8	8.7	4.4	4.9	6.8
		10+ years	9.3	3.2	1.3	1.2	3.6
	Inflation		-34.7	-5.5	-7.1	-15.6	-6.6
		1-2 years	-10.3	-1.5	-2.2	-4.7	-1.9
		2-10 years	-18.2	-3	-3.6	-8.3	-3.4
		10+ years	-6.2	-1	-1.3	-2.6	-1.3
	Growth rate		-31.4	-8.8	-9.4	-6.3	-6.9
		1-2 years	-8.9	-2.3	-2.8	-1.8	-1.9
		2-10 years	-16.4	-4.7	-4.8	-3.4	-3.5
		10+ years	-6.1	-1.8	-1.9	-1.1	-1.4
Non-marketable debt							
	Nominal return		27.7	13	7.3	4	3.4
	Inflation		-4.2	-0.4	-1	-2.1	-0.7
	Growth rate		-3.8	-0.8	-1.3	-0.9	-0.8
Primary Deficit/GDP			17.8	3.3	1.9	10.5	2

Notes:

[1.] Entries are all in percent.

[2.] For each column the entry for Change in Debt-GDP is approximately equal to the sum of rows 6, 10, 14, 19-22 following equation (8).

[3.] Entry in row 6 is equal to the sum of entries in 7-9. Entry in row 10 is the sum of entries in 11-13. Entry in row 14 is the sum of entries in 15-17.

[4.] The real returns on the various debt tranches can be calculated by adding the nominal return with the corresponding inflation component.

[5.] To find the market value of non-marketable debt we follow Hall-Sargent by undertaking the following adjustment:

$$\text{Non-marketable debt} = \frac{1}{\text{Price level}} * \text{Nonmarketable debt of Centre} * \frac{\text{Market value of Centre debt}}{\text{Par/Face value of Centre debt}}$$

Table 4: Security Level Debt Decomposition for Centre & State

		Period			
Start End		2005-2018	2005-2009	2009-2014	2014-2018
Debt-GDP					
	Start	49.1	49.1	48.4	47.8
	End	55.9	48.4	47.8	55.9
	Change	6.7	-0.7	-0.6	8.1
Marketable debt					
	Nominal return	39.6	10.1	11.7	17.8
	Inflation	-37	-8.7	-19.7	-8.6
	Real interest rate	2.8	1.3	-7.2	8.7
	Growth rate	-28.7	-11.5	-7.9	-9.2
Non-marketable debt					
	Nominal return	24.7	13.2	7.5	4
	Inflation	-9.5	-2.7	-5.2	-1.6
	Growth rate	-7.5	-3.6	-2.2	-1.7
Primary Deficit/GDP		23.2	1.8	13.7	7.8

Notes:
[1.] Entries are all in percent.
[2.] For each column the entry for Change in Debt-GDP is approximately equal to the sum of rows 6, 7, 9, 11-14 following equation (8). The RHS total for 2005–2018, 2005–2009, 2009–2014, 2014–2018 were 4.8, -1.5, -2.2, 8.5, respectively. The residuals are, 1.9, 0.8, 1.6, 0.4, for, 2005–2018, 2005–2009, 2009–2014, 2014–2018, respectively.
[3.] Real return for marketable debt is calculated by adding inflation component with the nominal return component.

5 Is Public Debt Sustainable?

We now take a closer look at the issue of debt sustainability for general government debt in India.[34] The standard criterion for assessing the sustainability of public debt is to compare the nominal interest rate (r) with the nominal growth rate, g (see Buiter and Patel (1992); Blanchard (2019)). Debt-GDP is sustainable if $r < g$, and not sustainable if $r > g$. As noted earlier to obtain a proxy for r using the aggregate data, we first calculate the "effective" interest rate. The data on

[34]Since our data goes up to 2018, we do not extrapolate implications for debt-GDP sustainability in the Covid-19 period (post March 2020) in India. We leave this for future work.

Table 5: Security Level Debt Decomposition for Centre & State by Maturity

			Period			
Start End			2005-2018	2005-2009	2009-2014	2014-2018
Debt-GDP						
	Start		49.1	49.1	48.4	47.8
	End		55.9	48.4	47.8	55.9
	Change		6.7	-0.7	-0.6	8.1
Marketable debt						
	Nominal return		39.6	10.1	11.7	17.8
		1-2 years	10.6	3	3.7	3.9
		2-10 years	22	5.6	6.6	9.8
		10+ years	6.9	1.5	1.4	4
	Inflation		-37	-8.7	-19.7	-8.6
		1-2 years	-10.5	-2.5	-5.6	-2.4
		2-10 years	-20.5	-4.6	-11.1	-4.8
		10+ years	-6	-1.5	-3	-1.5
	Growth rate		-28.7	-11.5	-7.9	-9.2
		1-2 years	-7.9	-3.2	-2.2	-2.4
		2-10 years	-15.8	-6.2	-4.5	-5.1
		10+ years	-5	-2.1	-1.2	-1.6
Non-marketable debt						
	Nominal return		24.7	13.2	7.5	4
	Inflation		-9.5	-2.7	-5.2	-1.6
	Growth rate		-7.5	-3.6	-2.2	-1.7
Primary Deficit/GDP			23.2	1.8	13.7	7.8

Notes:
[1.] Entries are in percent.
[2.] For each column the entry for Change in Debt-GDP is approximately equal to the sum of rows 6,10,14, 19-22 following equation (8).
[3.] The entries for nominal returns for marketable debt is approximately equal to the sum of entries for 1 year, 2–10 years, and 10+ years.
[4.] Real returns on the maturity tranches can be calculated by adding the nominal returns component with the inflation component for the same maturity tranche.

interest payments from the Ministry of Finance (Expenditure Budget), NIPFP (Long Term Fiscal Trends), and RBI pertains to combined interest payments on all liabilities. The effective interest corresponding to the general public debt is then obtained by multiplying the interest payments with the ratio of other government liabilities (Centre plus States) to general debt.

Figure 10 plots the effective interest rate against the nominal growth rate, g, between 1950–2018. As Figure 10 shows, nominal growth rates in India have been an order of magnitude higher than the effective interest rate on India's public debt consistently throughout 1959–2018, i.e., $r < g$.

Figure 11 undertakes a similar exercise using the Centre-State security level debt decomposition. For this, we consider three maturity tranches (1 year, 2-10 years, and 10+ years) to obtain a weighted average interest rate for Indian public debt over 2005–2018 a period during which both Centre and State security level data are available.[35] Between 2005–2018, we find that the weighted average interest, r, continues to be lower than g, apart from a single year 2015. This exercise confirms the debt sustainability result over the overlapping time period (2005–2018) using the aggregate data in Figure 10. Since we have precise security level Centre-State interest rate data, the weighted average interest rate is possibly a better proxy for the "true" interest rate burden of public debt compared to the effective interest rate from the aggregate data. Notwithstanding this, the sustainability of public debt in India ($r < g$) over the last 15 years or so is re-confirmed by the granular Centre-State security level data.

These results suggest that while public debt in India has been stable when seen both from a historical perspective and a more granular level, inflation played a quantitatively important role in liquidating the debt. Notwithstanding this, the security level analysis shows that the large contribution of nominal returns poses a challenge to debt management.

[35]The details of the weighted average interest rate calculations are provided in Appendix 7.2.

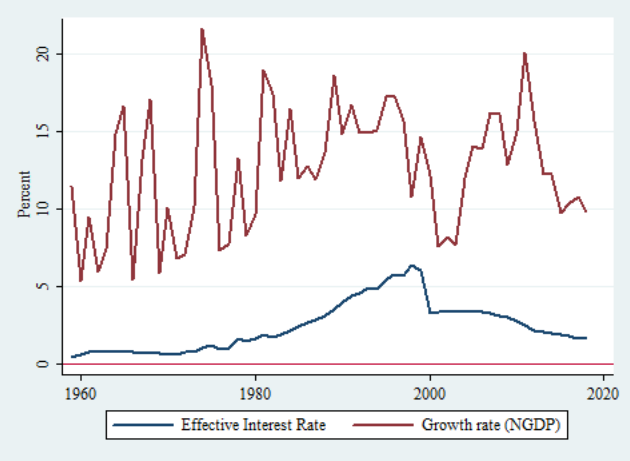

Figure 10: Effective Interest Rate Vs. Nominal Growth Rate

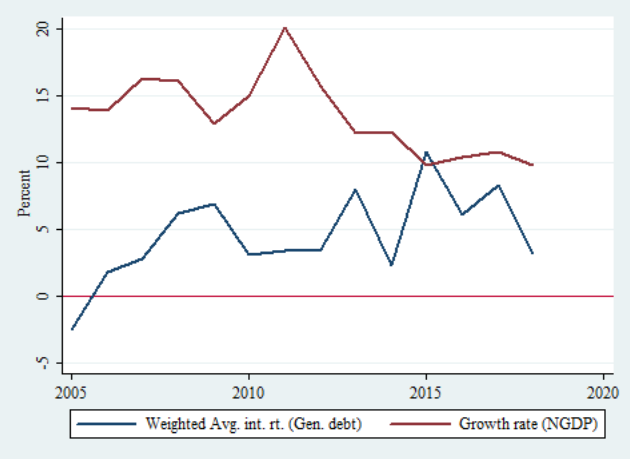

Figure 11: Weighted Average Interest Rate Vs. Nominal Growth Rate

5.1 Debt Liquidation And Volatility

The debt-decomposition exercise highlights two dominant channels of debt liquidation: economic growth and inflation. Debt liquidation via inflation can also be the outcome of fiscal dominance as in Reinhart and Sbrancia (2015). In this section we also check whether the volatility (measured by simple standard deviation), for three variables (household savings-financial and physical assets as a percentage of GDP, REER, and an uncertainty index as in Baker et al. (2016)) is comparatively more in the pre-FIT period (2003–2014) with the post-FIT period (2014–2018).[36] In addition we also look at the co-movements of these variables with inflation and growth components over 2003–2018.

Figure 12 plots each of the above variables in the pre-FIT regime (2003-2014) with the post-FIT regime (2014-2018) against the form of debt liquidation (inflation or growth). While we don't report the standard deviations of the variables, we find that in the pre-FIT regime, the volatility of all the variables (including the components) was higher when compared to the post-FIT years. The drop in volatility is considerably higher in the inflation component and the uncertainty index when comparing the pre-and post-FIT years.

When looking at the co-movement in the whole time period (2003–2018), we find that the relation between the inflation component and the uncertainty index is positive. The relation between the growth component and the uncertainty index is negative as expected. Tentatively, this suggests that while debt liquidation by growth tends to bring down uncertainty, debt liquidation via inflation led to more uncertainty in the economy. We also find that there is a positive co-movement between the REER and the growth component, but negative between the inflation component and the REER. This suggests that inflation induced pressure on the Indian Rupee to depreciate. Finally, while the co-movement between the inflation and growth components with household savings is less clear, in the post-FIT period, the growth component co-moves positively with household savings.

[36] We obtain the data on the real effective exchange rate from FRED (2020b). The data for household savings has been obtained from MOSPI (2012) and MOSPI (2020). Our analysis is from 2003–2018 because of the availability of the uncertainty index data from 2003 onwards. The inflation and growth components are obtained from Figure 8. A high value for each component implies higher debt liquidation.

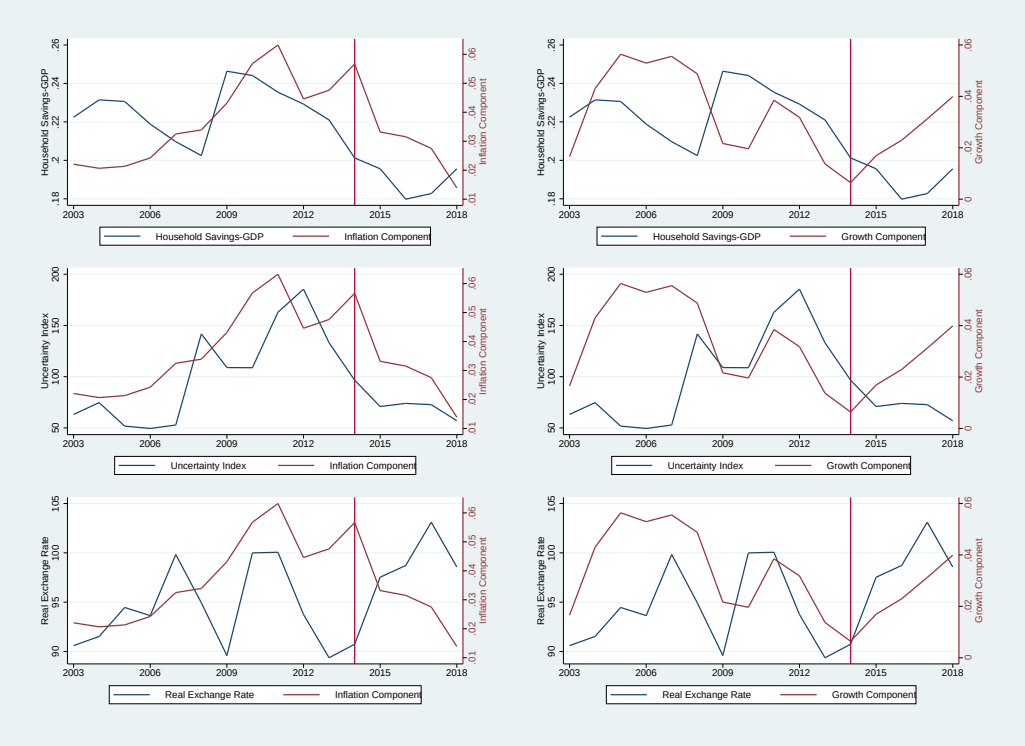

Figure 12: Co-movements of Variables vis-a-vis Inflation & Growth Rate

6 Conclusion

We assemble a novel data-set on Indian public debt that contains consistently defined aggregate annual components from 1951–2018, and Centre-State security level data from 2000–2018. Our debt decomposition on the aggregate data between 1959–2019 shows that inflation is the dominant component in reducing India's public debt, although it has begun to diminish after the de-facto adoption of flexible inflation targeting in India in 2014.

Next, we undertake a debt-decomposition following Hall and Sargent (1997, 2011) using outstanding Centre and State security level data between 2005–2018. We show that nominal returns on the marketable and non-marketable portions of the Centre's debt account for the highest contribution in explaining the change in public debt. This suggests that the nominal interest rate is the predominant component driving the change in the debt-GDP ratio during this period.

Inflation's growing contribution since 1951 to lowering public debt lends support to the hypothesis that the sustainability of Indian public debt has been helped by debt liquidation in an

environment of fiscal dominance. While we find that $r < g$ in both the aggregate data and the security level data, our analysis highlights a potential risk that the nominal interest component of public debt poses for debt-GDP dynamics. We also find that in the pre-FIT period volatility in the variables associated with fiscal dominance was higher. This suggests a possible link between debt liquidation via inflation and its impact on volatility and uncertainty in the economy, an aspect of fiscal dominance that we hope to develop in future work.

While we think our analysis is valuable for fiscal policy setting in India, we feel that our results can be taken in several directions. First, our analysis tells us that a more accurate way to look at debt-sustainability in other EMEs (which may have similar data problems as India) is to use granular security level data rather than aggregate data. This is because the residuals are much smaller. Second, given that the decomposition allows us to quantify inflation's role in debt-liquidation historically, a natural question to ask is whether we can quantify the role of unanticipated inflation and anticipated inflation separately in the decomposition by extending the Hall-Sargent framework. This would quantify the role of unanticipated inflation, say, as a fiscal shock absorber in episodes in India/EMEs where public debt surged. Finally, while the costs and benefits of adopting flexible inflation targeting are actively debated, our paper shows that at least in the Indian case, flexible inflation targeting reduced the extent of fiscal dominance.

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7 Technical Appendix (For Online Publication)

7.1 Data Description

In India both Centre and States can raise debt by issuing government securities (or G-sec in short). A G-sec is a tradeable instrument that can be both short-term (like treasury bills) or long-term (dated securities) in nature. Treasury bills are securities of maturity one year or less and dated securities or bonds are those with maturity more than a year. In India the central government issues both treasury bills and dated securities and the states issue only dated securities called State Development Loans (SDL). In this paper we consider aggregate and security level debt data for both Centre and States. The aggregate debt data for both Centre and States is collected from 1959–2018 and that for security level data it is from 2000–2018.

7.1.1 Aggregate debt: Centre And States

Public debt for the Centre includes debt contracted under the Consolidated Fund of India and as liabilities under Public Account. The aggregate Centre debt classification is shown in Figure 13. Other than public debt government also receives funds as liabilities under Public Account whose classification is shown in Figure 14.

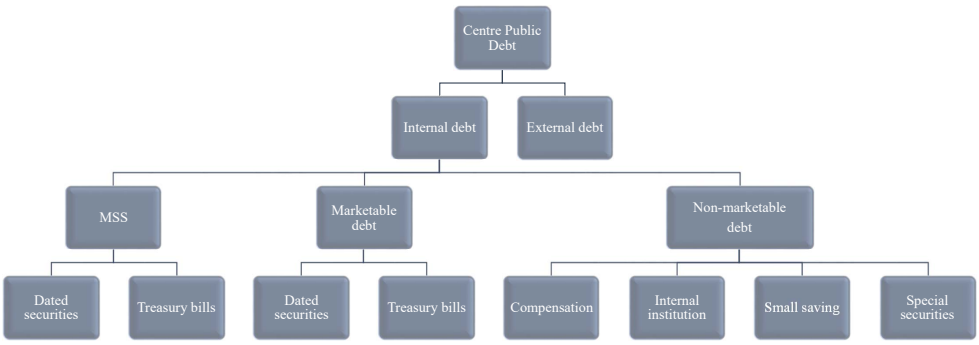

Figure 13: Centre Debt Classification

A similar classification of debt and liabilities exist for the States with some exceptions. Unlike the Centre the States cannot raise debt in the international market and thus external debt is absent

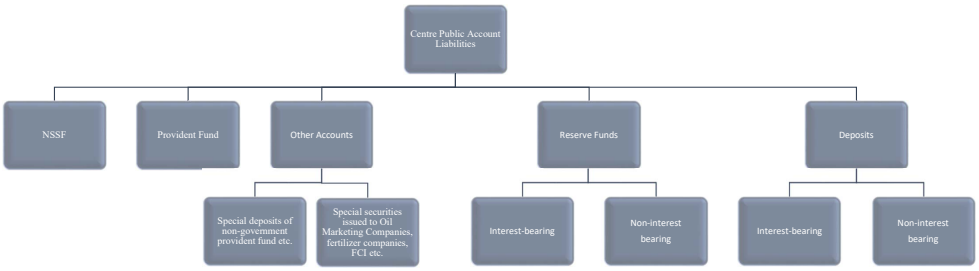

Figure 14: Centre Liabilities Classification

for the States. Also, States cannot issue treasury bills and thus issuance of debt for the States is restricted to long-term instruments i.e., those with maturity more than a year. Figures 15 and 16 shows the details of States' debt and liabilities.

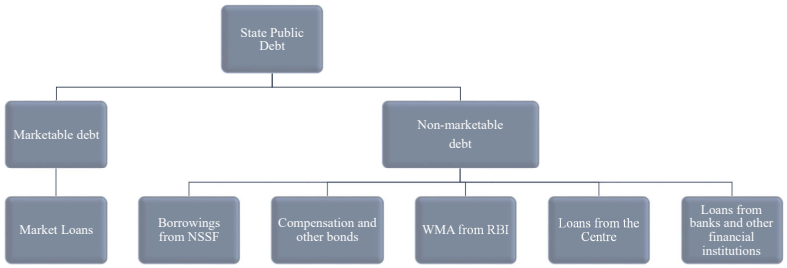

Figure 15: State Debt Classification

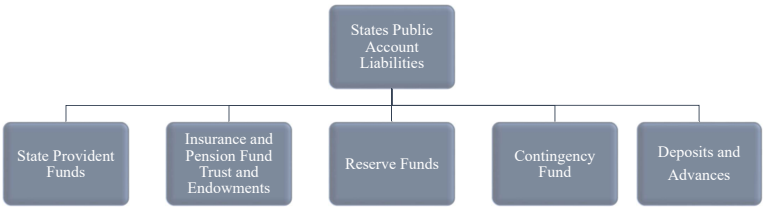

Figure 16: State Liabilities Classification

7.1.2 General Debt And Liabilities

For the analysis we use general public debt that includes both Centre and States' public debt. Accordingly, we make adjustments that account for common items and is calculated as follows:

$$\begin{aligned} \text{General debt} = {} & \text{Centre debt} + \text{States debt} \\ & - \text{States investment in Treasury bills of Centre} \\ & - \text{Loans from Centre to States} \end{aligned} \tag{10}$$

where,

$$\begin{aligned} \text{Centre debt} = {} & \text{Internal debt} + \text{External debt} \\ = {} & \text{Marketable} + \text{Non-Marketable} + \text{External debt} \\ = {} & \text{dated securities} + \text{treasury bills (91-day + 364-day + 182-day)} \\ & + \text{14-day treasury bills} \\ & + \text{Special securities issued in conversion of treasury bills} \\ & + \text{Compensation and other bonds} \\ & + \text{Other special securities issued to international financial institutions/Special floating bonds} \\ & + \text{NSSF Securities} + \text{Others} + \text{External debt} \end{aligned} \tag{11}$$

External debt is considered at historical exchange rate instead of current exchange rate as the former is available from 1950 onwards and the latter is available from 1974 onwards. External debt data at historical exchange rate from 1974–1980 is taken from NIPFP and the relevant data post 1980 is taken from RBI.

$$\begin{aligned}\text{State debt} &= \text{Marketable debt} + \text{Non-Marketable debt} \\ &= \text{Market loans} \\ &+ \text{Borrowings from NSSF} \\ &+ \text{Compensation and Other Bonds} \\ &+ \text{WMA from RBI} \\ &+ \text{Loans from Centre} \\ &+ \text{Loans from banks and other financial institutions}\end{aligned} \tag{12}$$

It is important to note here that in our analysis we do not include liabilities for both Centre and States. Liabilities are not used by the government to fund the deficit and debt is directly related to funding of deficits. Since our analysis involves decomposition of debt we therefore consciously exclude the liabilities. In our decomposition exercise we look at primary deficit and not fiscal deficit. Fiscal deficit includes interest payments, whereas, primary deficit does not. In our debt decomposition exercise we use primary deficit because we account for the role of nominal interest rates as a separate component. Therefore, we only include those government funds that has a direct bearing on the primary deficit. The items under public debt for both Centre and State are directly related to the primary deficit whereas those under liabilities are not associated with funding the deficit (Ministry of Finance, 2012).

7.1.3 Security level data: Centre And States

For the security level debt decomposition we also consider general debt,i.e., debt for the Centre and States. We begin by looking at the securities issued by the Centre and States. For both Centre and States we look at securities issued and not matured as of end March every year. For Centre securities our data begins from 2000 and for State securities data starts from 2004.

The Centre securities' data is collected from Status Papers published by the Ministry of Fi-

nance.[37] We consider all outstanding Centre securities since 2000. We track each of these securities until maturity and collect the face value outstanding as of end March each year for each security. We then retained only those securities for which the amount outstanding was equal to the aggregate debt value for a particular year.[38] From the selected securities by keeping track of the month and year of maturity of each security we constructed the principal and coupon matrices used in our analysis. So that across each year we have principal and coupon entries under maturities of one year, two years, three years etc. until 30 years. This is obtained by summing over the principal and coupons coming from all securities. For the price series we used the yield to maturity data from RBI.

For State securities the procedure and criteria used to select the securities was similar to that of the Centre's. Our main data sources were the Statements on State Government Market Loans from the 'State Finances: A Study of Budgets' (Reserve Bank of India, 2004) for various years, Public Debt Statistics from RBI, and RBI Press Releases.[39] We collected the security level data for each State and taking into account the fact that there were cases when the States have been bifurcated. This was the case for Bihar, Madhya Pradesh, and Uttar Pradesh. In such cases the loans pertaining to the public debt were bifurcated in the population ratio of: 74.71% and 25.29% for Bihar and Jharkhand, respectively. For Madhya Pradesh and Chattisgarh the division was 73.4% and 26.6%, respectively. Finally, it was about 95% and 5% for Uttar Pradesh and Uttaranchal, respectively. The face values for such securities had been populated accordingly. Also, in order to calculate the principal and coupon matrices we required data on the issue date, specifically, the issue month was important as it would then help guide as to when the coupons were due. In order to trace when certain securities were issued, we fetched data for the issuance of SDLs from RBI. Three sources were used for this: Auction data (2006–2018), SGL data (1996–2002) and various press releases

[37] Status Papers are published every year since 2010.

[38] This criterion of matching the outstanding debt in each year and led to many securities being dropped out and eventually led to the start year of the analysis to be 2000. An alternative data source could have been the data from RBI that started from 1996. However, one limitation of using that dataset was that the relevant table reported only securities issued in a particular year. This meant we would miss out on the securities that were issued prior to 1996 and had not matured as of 1996.

[39] See State Government Market Loans. This statement is not available for 2005 and hence the list of securities outstanding in 2005 have been populated using 2004 and 2006 data.

(Tap Sales).

7.2 Debt Sustainability Equation

The weighted average interest rate is the calculated as follows:

Centre securities' weighted average interest rate:

$$r_t^{\text{cen}} = r_{1,t}^{\text{cen}} \frac{\tilde{B}_{1,t}^{\text{cen,m}}}{(\tilde{B}_t^{\text{cen},m} + \tilde{B}_t^{\text{cen},nm})} + \sum_{j=2}^{10} r_{j,t}^{\text{cen}} \frac{\tilde{B}_{j,t}^{\text{cen,m}}}{(\tilde{B}_t^{\text{cen,m}} + \tilde{B}_t^{\text{cen,nm}})} + \sum_{j=11}^{30} r_{j,t}^{\text{cen}} \frac{\tilde{B}_{j,t}^{\text{cen,m}}}{(\tilde{B}_t^{\text{cen,m}} + \tilde{B}_t^{\text{cen,nm}})}$$

$$+ r_t^{\text{cen,nm}} \frac{\tilde{B}_{1,t}^{\text{cen,nm}}}{(\tilde{B}_t^{\text{cen},m} + \tilde{B}_t^{\text{cen},nm})} \tag{13}$$

where, $r_{j,t}^{\text{cen}}$ and $\tilde{B}_{j,t}^{\text{cen,m}}$ is the interest rate and the corresponding marketable debt for j-year maturity tranche of Centre securities at time t for $j = 1, 2-10, 10+$ years. And $r_t^{\text{cen,nm}}$ and $\tilde{B}_t^{\text{cen,nm}}$ is the interest rate and the corresponding non-marketable debt at time t for Centre.

States' securities' weighted average interest rate:

$$r_t^{\text{sta}} = r_{1,t}^{\text{sta}} \frac{\tilde{B}_{1,t}^{\text{sta,m}}}{(\tilde{B}_t^{\text{sta},m} + \tilde{B}_t^{\text{sta},nm})} + \sum_{j=2}^{10} r_{j,t}^{\text{sta}} \frac{\tilde{B}_{j,t}^{\text{sta,m}}}{(\tilde{B}_t^{\text{sta,m}} + \tilde{B}_t^{\text{sta,nm}})} + \sum_{j=11}^{30} r_{j,t}^{\text{sta}} \frac{\tilde{B}_{j,t}^{\text{sta,m}}}{(\tilde{B}_t^{\text{sta,m}} + \tilde{B}_t^{\text{sta,nm}})}$$

$$+ r_t^{\text{sta,nm}} \frac{\tilde{B}_{1,t}^{\text{sta,nm}}}{(\tilde{B}_t^{\text{sta},m} + \tilde{B}_t^{\text{sta},nm})} \tag{14}$$

where, $r_{j,t}^{\text{sta}}$ and $\tilde{B}_{j,t}^{\text{sta,m}}$ is the interest rate and the corresponding marketable debt for j-year maturity tranche of States' securities at time t for $j = 1, 2-10, 10+$ years. And $r_t^{\text{sta,nm}}$ and $\tilde{B}_t^{\text{sta,nm}}$ is the interest rate and the corresponding non-marketable debt at time t for the States.

Centre and States' securities' weighted average interest rate:

$$r_t^{\text{gen}} = \frac{(r_{1,t}^{\text{cen}} \tilde{B}_{1,t}^{\text{cen,m}} + r_{1,t}^{\text{sta}} \tilde{B}_{1,t}^{\text{sta,m}})}{(\tilde{B}_t^{\text{cen,m}} + \tilde{B}_t^{\text{cen,nm}} + \tilde{B}_t^{\text{sta},m} + \tilde{B}_t^{\text{sta},nm})} + \sum_{j=2}^{10} \frac{(r_{j,t}^{\text{cen}} \tilde{B}_{j,t}^{\text{cen,m}} + r_{j,t}^{\text{sta}} \tilde{B}_{j,t}^{\text{sta,m}})}{(\tilde{B}_t^{\text{cen,m}} + \tilde{B}_t^{\text{cen,nm}} + \tilde{B}_t^{\text{sta,m}} + \tilde{B}_t^{\text{sta,nm}})}$$

$$+ \sum_{j=11}^{30} \frac{(r_{j,t}^{\text{cen}} \tilde{B}_{j,t}^{\text{cen,m}} + r_{j,t}^{\text{sta}} \tilde{B}_{j,t}^{\text{sta,m}})}{(\tilde{B}_t^{\text{cen,m}} + \tilde{B}_t^{\text{cen,nm}} + \tilde{B}_t^{\text{sta,m}} + \tilde{B}_t^{\text{sta,nm}})} + \frac{(r_t^{\text{cen,nm}} \tilde{B}_t^{\text{cen,nm}} + r_t^{\text{sta,nm}} \tilde{B}_t^{\text{sta,nm}})}{(\tilde{B}_t^{\text{cen,m}} + \tilde{B}_t^{\text{cen,nm}} + \tilde{B}_t^{\text{sta,m}} + \tilde{B}_t^{\text{sta,nm}})} \tag{15}$$

where, $r_{j,t}^{\text{gen}}$ and $\tilde{B}_{j,t}^{\text{gen,m}}$ is the interest rate and the corresponding marketable debt for j-year maturity tranche of Centre and States' securities at time t for $j = 1, 2 - 10, 10+$ years. And $r_t^{\text{cen,nm}}$, $r_t^{\text{sta,nm}}$, and $\tilde{B}_t^{\text{cen,nm}}$, $\tilde{B}_t^{\text{sta,nm}}$ are the interest rates and the corresponding non-marketable debt at time t for Centre and States, respectively.

7.3 Data Sources

Table 6: Data Sources

Variable		Source	Time period	Remarks
Aggregate debt	Centre	Outstanding debt as of end March each year from Long Term Fiscal Trends published by NIPFP.	1950–1980	
		Outstanding debt as of end March each year from Status Papers published by Ministry of Finance.	1981–2018	The Ministry of Finance started publishing Status Paper on Government Debt from 2010.
	States	Outstanding debt as of end March each year from Long Term Fiscal Trends published by NIPFP.	1951–1980	Long Term Fiscal Trends had State debt data going back till 1951, though two components of State debt data (Provident Funds etc. and Loans from other banks and institutions) are missing from 1951-1959. We merged the data from NIPFP with that of Ministry of Finance to have the data from 1951 onwards.
		Outstanding debt as of end March each year from State Finances from RBI.	1981–2018	
Security level debt	Centre	Status Paper Appendix Table: HB2: Outstanding Central Government Securities.	2000–2018	This dataset dataset is from 2000-2017. The 2018 data is appended from Status Paper 2017-2018.
	States	State Finances Statement 25: State Government Market Loans.	2005–2018	This statement is not available for 2005 and hence the list of securities outstanding in 2005 have been populated using 2004 and 2006 data.
GDP		DBIE from RBI.	1951–2018	
Inflation		CPI data from OECD/RBI (Base year 2001).	1958–2018	CPI Industrial Workers (CPI-IW).
Interest rate		Combined Interest payments on all liabilities from Long Term Fiscal Trends published by NIPFP.	1951–1980	We use "Effective" interest rate for our debt decomposition exercise. The details of the calculation are provided in the paper.
		Combined Interest payments on all liabilities from RBI.	1981–2018	
Primary Deficit		Combined Gross Primary Deficit from Long Term Fiscal Trends published by NIPFP.	1951–1980	The numbers coming from Long Term Fiscal Trends are revenue expenditure and capital expenditure (net of loan recovery).
		Combined Gross Primary Deficit from RBI.	1981–2018	The numbers coming from RBI are calculated as: Total expenditure (Table 96, RBI) minus Loan Recovery (Table 95, RBI).

Notes:

1. NIPFP is National Institute of Public Finance and Policy.

2. RBI is Reserve Bank of India.

3. DBIE is Database of the Indian Economy