How to Finance the Stimulus: Debt Financing Vs Monetisation of Deficit

Context:

- Economic Slowdown aggravated by the onslaught of COVID-19 pandemic.

What should government do at this juncture of slowdown?

- Government should intervene to revive the economy (Keynesian Economics)
- For this, a greater public spending by government is considered as the sine qua non of such a revival.

What is the challenge of increased govt spending?

- Greater public spending will increase the fiscal deficit and this expansion has to be financed.
- Fiscal deficit is the **total amount of borrowings required** to bridge the gap between government's spending and revenues.
- There are different ways of financing the expansion
- Theoretically fiscal deficit can be financed by higher taxes, but when the economy is slowing it is unpopular & prevents further spending by people
- This involves borrowing from public (issuing bonds), borrowing external sources like World Bank and the International Monetary Fund (IMF)
- This involves government selling treasuries to Reserve Bank of India (RBI)

What are the challenges with Debt Financing?

- Borrowing from World Bank & IMF usually comes with conditionality on Economic restructuring (recall 1991 reforms that was part of bailout package)

- Increased borrowings now means increase in interest payment for future generation and reduced scope for borrowing
- Not only have the moneys to be repaid, they will have to be paid back in hard currency.
- This would involve India having to earn hard currency by stepping up exports which is herculean task under present global mood of protectionism.
- For ex: If a stimulus of approximately 10% of the GDP is envisaged, with exports at 25% of GDP, it would imply stepping up exports by close to 50%.
- A loan is bound to take some time to be negotiated, taxing the energies of a government that ought to be engaged in the day to day battle with COVID-19.

What is direct monetisation or money financing?

- In layman's language, monetisation of deficit means printing more money.
- In direct monetisation, the government asks RBI to **print new currency in return for new bonds** that the government gives to the RBI.
- In lieu of printing new cash**,** which is a liability for the RBI (since, every currency note has the RBI Governor promising to pay the bearer the designated sum of rupees), RBI gets government bonds, which are an asset for the RBI
- Government bonds are asset to RBI because they carry the government's promise to pay back the designated sum at a specified date.
- Now, the government would have the cash to spend and alleviate the stress in the economy
- Note that this is different from the **"indirect monetisation"** that RBI does when it conducts the Open Market Operations (OMOs) and purchases bonds in the secondary market.

Is direct monetisation practised in India?

- Monetisation of deficit **was in practice in India till 1997**, whereby the central bank automatically monetised government deficit through the issuance of ad-hoc treasury bills.

- Two agreements were signed between the government and RBI in 1994 and 1997 to completely phase out funding through ad-hoc treasury bills.
- And later on, with the enactment of **FRBM Act, 2003,** RBI was completely barred from subscribing to the primary issuances of the government from April 1,2006
- It was agreed that henceforth, the RBI would operate only in the secondary market through the OMO (open market operations) route i.e. **Indirect Monetisation**
- OMOs involve the sale and purchase of government securities to and from the secondary market by the RBI to adjust the rupee liquidity conditions
- The implied understanding was that the RBI would use the OMO route not so much to support government borrowing but it would be used as a liquidity instrument.

What are the disadvantages of Direct Monetisation which lead to its discontinuation?

- Monetisation involve expansion of money supply that can potentially result in inflation
- Availability of direct monetization route means reduced incentive for government to be fiscally disciplined.
- Governments would usually spend on populist measures rather than long-term structural measures knowing fully well that they have a way out for increased fiscal deficit.
- The usage of direct monetisation route recklessly caused fiscal indiscipline that ultimately led to the balance of payments crisis in 1991.
- When there is excess supply of the currency due to printing of new currency, it could lead to a fall in rupee value, leading to its depreciation.
- Markets/Investors will fear that the constraints on fiscal policy are being abandoned, when direct monetisation path is adopted. They may see the government as planning to solve its fiscal problems by inflating away its debt.

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Won't indirect monetisation (through OMO) lead to Inflation?

- Both monetisation and OMOs involve expansion of money supply that can potentially result in inflation.
- However, the inflation risk that both carry is different.
- OMOs are a monetary policy tool with the RBI deciding on the amount of liquidity to be injected in and when to.
- In contrast, in direct monetisation, the quantum and timing of money supply is determined by the government's borrowing rather than the RBI's monetary policy, to fund the fiscal deficit.
- If RBI is seen as losing control over monetary policy, it will raise concerns about inflation and RBI's credibility to manage money supply.
- Therefore, forsaking RBI credibility can be costly, with wider implications for the economy both in the short- and long-terms.

Can Direct monetisation be used to finance the deficit in post-COVID period?

- Change in economic situation calls for change in policies.
- Inflationary impact of direct monetisation may not be very high at this juncture of Indian economy due to the demand slowdown the economy is experiencing.
- Increased money supply will revive the depressed demand and kickstart production reviving the economy.
- However, when the economy enters the recovery path, increased money supply could proportionately lead to a higher inflation rate.

Conclusion

- Money financing is a viable route to take us back to pre-COVID-19 levels of output.