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POLICY BRIEF

India's Deficit Monetization Dilemma and a Solution: A Revamped Budget

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Deficit Monetization: India's Dilemma

It is becoming increasingly clear that following the Covid-19 pandemic, the Indian government will have to provide massive support to the health sector, the poor and vulnerable citizens, the small firms and the economy as a whole, over this year 2020-21. There is a strong consensus, with support from past central bankers, that a sizeable part of this expenditure will have to be funded by the RBI, i.e., the deficit will have to be monetized. In terms of macroeconomic policy stance, one major shift that is taking place is understanding that this crisis will need fiscal dominance to make a comeback and monetary policy will have to play a supportive role. Understanding this change, many countries have moved towards some form of deficit monetization in these dire times. Box 1 describes some of these policies in different countries.

Oddly enough, this thinking is not shared by Indian policymakers. A recent article in the Business Standard reported that the RBI was pushing back any direct or indirect monetization of the central government's fiscal deficit till the second half of the fiscal year (Chaudhury, 2020). Policy experts close to the government, including N.K. Singh, the Chairman of the Fifteenth Finance Commission, have argued that monetization of the deficit is not in the best interests of the country. Why is the government so reluctant to go down this path and is this a sound move by the government? If not, what other options that we have?

Forms of Deficit Monetization

The reluctance that the RBI and the government is exhibiting towards monetizing the deficit could be due to three reasons.

- The first is that the policymakers do not want to undo the significant reforms that have been implemented in the monetary policy framework over the last three decades.
- The second is a concern with major financial outflows, particularly if there is a downgrading in our ratings as a result of any deficit monetization.
- The third is a worry that any monetization could be inflationary, especially if the disruptions from the lockdowns lead to major supply bottlenecks.

Each of these concerns are real and should definitely be considered seriously when any policy is framed in this context. However, there are a number of counterpoints that also need equal consideration.

- First, it must be understood that the reforms in the monetary framework that have been adopted till now all work towards maximising the gains from our financial openness. While these reforms will need to

Box 3: Global Attitude Towards Monetization Has Changed In Order To Fight The Crisis

- The US Fed has started purchasing very large volumes of Treasury Securities and Municipal Bonds, thereby supporting the expenditure of the Federal as well as Municipal governments.
- The European Central Bank eliminated a cap on how many bonds it can buy from any single euro zone country.
- The Bank of Canada has declared that it will buy Government of Canada securities in the secondary market and began with purchases of five billion Canadian Dollar per week, across the yield curve.
- Amongst developing countries, Indonesia has recently changed its laws that allowed its central bank to buy government bonds only in the secondary market. Now, in a situation in which the market is unable to fulfil the government's financing target, the Indonesian Central Bank can buy government securities from the primary market.

Source:

The New York Times, 2020. With $2.3 Trillion Injection, Fed's Plan Far Exceeds Its 2008 Rescue.
Financial Times, 2020. ECB shakes off limits on new €750bn bond buying plan.
Reuters, 2020. Bank of Canada expected to buy C$200 billion of debt as it embraces QE.
The Jakarta Post, 2020. Bank Indonesia buys $108m of government bonds at auction, first time since rule change

be relaxed temporarily for monetization (as has been done, for example, in Indonesia), in a post-Covid-19 world, the discipline of the financial markets will surely ensure a quick return to a regime of fiscal discipline.

- Second, while a reversal of financial flows during the crisis is possible if we monetize some of our deficit, we need to weigh this against the likelihood of an even stronger financial outflow that may result from the economy crashing due to an insufficiently large stimulus, which may happen if we rule out monetization.
- Third, as far as inflation is concerned, there seems to be consensus that there is very little probability of this during the first half of the year, when we will most probably face a very large demand meltdown. It is, in fact, during the latter part of the year - when private demand could possibly make a comeback - that we might run into supply bottlenecks and inflationary episodes. If, the government is forced to monetize their debt at that point (to continue funding the health crisis for example), we will definitely have to contend with inflationary expectations.
- Fourth and perhaps most importantly, it must be recognized that the volume of funds needed to mitigate this crisis are simply enormous, and market borrowings may simply not suffice. In a recent opinion piece in the Business Standard, and Devesh Kapur and Arvind Subramanian show that even with optimistic assumptions about the length of the lockdowns, a sizeable monetization will be necessary (Kapur and Subramanian, 2020).

So what would be a balanced approach to this issue that would consider both sets of concerns? Thinking through the concerns about the undoing of monetary reforms, the financial outflows due to diminished ratings, and the possibility of encouraging inflationary expectations, it immediately becomes clear that the main problem related to deficit monetization is that it raises questions about the credibility of our policies and the capacity to manage expectations. In normal times, these issues are dealt with by ensuring fiscal discipline. In a crisis, fiscal discipline is not an option that we have, and it seems like some part of the deficit will definitely need to be monetized. If this is true, then the current approach by the government to try and avoid monetization as long as possible, and to push it to the second part of the year, if absolutely necessary, is not a balanced approach at all. The lack of a clear underlying plan robs it of any credibility and there is nothing specific in it that makes an attempt at managing expectations.

Policy Recommendation

- **A more balanced approach would involve coming out with a revamped budget for this year, spelling out the government's plans and priorities in terms of revenues and expenditures and a clear plan for funding the deficit, including market borrowings and monetization.**

- **Inflationary tendencies will probably be negligible right after the lockdown is lifted due to a demand meltdown. However, this may not be true during other periods, particularly the second part of the year, when private demand may make a comeback. This suggests that a large part of the monetization should happen during the first part of the year, when the challenge of managing inflationary expectations are not severe.**

There are two clear advantages of such a budgeted monetization plan. The first is that it will enable the private sector understand the overall economic approach and plan their activities accordingly and this will definitely help a recovery. Secondly, even the foreign investors and rating agencies will feel less risk-averse with a budget, as it will signal an economy with a clear and transparent economic plan to combat the crisis.

References

Chaudhury, A., *RBI unlikely to monetise Centre's Fiscal deficit in first half of FY21, in Business Standard, April 20,2020.*

Kapur, D. and Subramanian, A., *Fiscal space: Not if but how,* in Business Standard, April 12, 2020.

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