



सत्यमेव परमो धर्मः

This Time (It) Is Different: Deficit Monetization during an Epidemic is not Fiscal Profligacy-Sabyasachi Kar and Siddharth Naidu

The Present and the Past

There is a strong consensus among Indian policy experts that the government will have to come up with a significant stimulus to combat the Covid-19 epidemic. Most also argue that a sizeable part of this expenditure will have to be funded by the RBI, i.e., the deficit will have to be monetized. This argument however, has met with some opposition from other experts, and currently, the government and the RBI also seems reluctant to go down this path. The Indian government's reluctance to monetize our deficits is, at least partly, due to our experience with this practice in the past, when it became closely related to fiscal profligacy. Box 1 describes the sequence of policies and reforms that are a part of this chequered history.

Forms of Deficit Monetization

The Covid-19 pandemic is, however, no regular phenomenon. Attacking both lives and livelihoods, it has the capability to set all progress back by decades, if not more. 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. India's reluctance to go down this path is understandable, given our history with fiscal profligacy in the past. However, we should have more confidence in the resilience of the reforms in our monetary framework. While these reforms will need to be relaxed temporarily for monetization (as has been done, for example, in Indonesia), in

Box 1: From Fiscal Profligacy to Monetary Reform

- ❖ The genesis of this phenomenon can be traced back to agreements between the government and the RBI in the years 1937 and 1955.
- ❖ Under these agreements, any fall in the government's cash reserves with the RBI below a certain threshold would be automatically monetized by the creation of treasury bills, also known as T-bills.
- ❖ During the 1980s, the centre's fiscal deficit started increasing rapidly with the decadal average going up to 6.7% of GDP, compared to 3.8% in the previous decade.
- ❖ The automatic monetization of these deficits and an administered interest rate mechanism during that period meant that monetary policy was completely ineffective and dominated by fiscal policy.
- ❖ This pre-reform period was also characterised by structural bottlenecks and acute supply constraints due to statist policymaking. The supply bottlenecks and the profligate money creation together led to frequent inflationary surges during this period.
- ❖ Steps to correct this situation began in the 80s. In 1986, the RBI started to auction these T-bills in order to open up public debts to the market and relieve some of RBI's own burden.
- ❖ In 1994, an agreement was signed between the government and RBI to impose some restrictions on issuance of T-bills. Finally, an agreement was signed in 1997 which completely phased out these treasury bills.
- ❖ With the automatic monetization mechanism out of the way, focus returned to limiting the size of the fiscal deficit, as it would otherwise lead to indirect monetization. Under the FRBMA Act of 2003, the centre's fiscal deficit was legally capped at 3% in order to achieve this.
- ❖ The establishment of Inflation Targeting (IT) framework in 2016 further consolidated this approach and monetary policy actions moved away from fiscal considerations.

Source:

Basu, K. and Maertens, A., 2012. *The New Oxford Companion To Economics In India*. New Delhi: Oxford University Press India.

RBI, 2013. *Report On Currency And Finance 2009-12: Fiscal- Monetary Co-Ordination*.

a post-Covid-19 world, the discipline of the financial markets will surely ensure a quick return to a regime of fiscal discipline. Moreover, a judicious mixture of different forms of monetization will have to be adopted.

Box 2 describes the different forms of deficit monetization. If any government runs up a deficit, then it can either be financed by a debt instrument purchased by a private investor or be monetized by the central bank of the country. However, in practice, the distinction between debt financing and monetization are not always very clear. One must keep in mind that there is a second unconnected reason why central banks purchase and sell government bonds from the secondary market, namely, the enforcement of monetary policy objectives, particularly, liquidity management. Not surprisingly then, it frequently becomes difficult to distinguish deficit monetization from normal liquidity management activities of the central bank. Broadly, this indirect deficit monetization is identified as the central bank's purchases in the secondary market which is inconsistent with its monetary policy objectives.

Policy Recommendation

If India has to monetize at least a part of her deficits in order to fight the current crisis, what form should such a policy take? Should it be monetised only indirectly, so that we do not need to go against the FRBM act? If not, then should the direct monetisation be temporary or should it be permanent in nature? To answer these questions satisfactorily, it is important to understand

the advantages and disadvantages of each of these in the current scenario.

- Indirect monetisation of the deficit works well within the FRBM framework and may be the preferred option, provided the interest rates are not too high in the secondary markets. However, if large funds become necessary, then interest rates could go up. In such a situation, direct monetisation is a preferred option as it is a private placement of the government securities with the central bank. **Thus, the monetization should include purchases of central government securities both in the primary and secondary market.**
- Monetization of deficits raise questions about the solvency of governments. This is why, it will be prudent to treat most of the monetization as temporary, with the RBI selling off the government securities when the crisis is over. Moreover, this might also be necessary keeping in mind the potential for inflationary impulses that the monetization could give rise to later on. **Thus, the purchase of government securities should be mostly in the form of temporary monetization, since the money is provided specifically for the period of the crisis.**
- Should we consider the strongest form of monetisation at all – i.e., a permanent monetization of the government's debt by the central bank? Despite the reputational costs associated with a permanent monetization, they become necessary when economies get caught in debt traps. **Whether some of the monetisation in India will become permanent will depend on how much resilience the Indian economy shows after the crisis.**

Box 2: Different Modes of Deficit Monetization

1. Central bank directly purchasing government bonds in the primary market and providing the government with money, which will then fund the deficit.

- 1.1 Temporary monetization if the central bank later sells off the bonds in the secondary market.
- 1.2 Permanent monetization if the central bank subsequently writes off this government debt

2. Central bank purchases government bonds from the secondary market. This enables private investors to use funds received from their transaction with the central bank to then purchase government bonds from the primary market, thus monetizing the deficit indirectly.

3. Another mode of deficit monetization that became widely debated recently in India involves the Central Bank transferring its excess reserves to the government budget. This is also deficit monetization in effect, since the money supplied to the government would have had to be borrowed otherwise from private investors.

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