Deficit Monetisation by the RBI

What is the issue?

- The Union Finance Minister recently remarked that she was keeping her options open on monetisation of the deficit by the RBI.
- How the government and the RBI decide on this will have significant implications for India's economic prospects, and here is an overview on that.

What is the present deficit scenario?

- Indian economy is passing through an unprecedented phase, and so is the fiscal health of the country.
- Apparently, the government will not be able to achieve its FY21 fiscal deficit target of 3.5% of GDP.
- The exchequer is facing a revenue crunch due to falling tax revenue post the lockdown.
- There is also difficulty in realising the disinvestment target in an uncertain market.
- Adding to it, the RBI has projected a negative GDP growth rate for the Indian economy in FY21.
- The Government has even raised its gross market borrowing for FY21 by 54% (Rs 7.8 - 12 lakh crore).
- Given these, the fiscal deficit as a percentage of GDP may even cross the double-digit mark.
- The government stimulus package of Rs 20 lakh crore also seems to be inadequate to revive the economy.
- As is seen, a large part of it accounts for liquidity-boosting measures by the RBI.
- Because, the weak fiscal position has forced the government to restrict the stimulus.
- It is in this scenario, that the need for monetisation of deficit has been widely felt.

What is monetisation of deficit?

- In simple terms, monetising the deficit is equal to the central bank creating money to help the government meet its expenditure.
- In layman's language, this means printing more money ('monetisation'), which is direct monetisation.
- In other way, deficit monetisation happens when the RBI buys government securities directly from the primary market to fund government's expenses.
- This is a kind of implicit monetisation.

How have the modes evolved?

- Monetisation of deficit was in practice in India till 1997.
- Back then, the central bank automatically monetised government deficit.
- It does it through the issuance of ad-hoc treasury bills.
- However, two agreements were signed between the government and RBI in 1994 and 1997.
- This was to completely phase-out funding through ad-hoc treasury bills.
- 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.
- [OMOs involve the sale and purchase of government securities to and from the 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.
- Instead, it would be used as a liquidity instrument.
- This was to manage the balance between the policy objectives of supporting growth, checking inflation and preserving financial stability.

How does it work?

- Direct monetisation (or simply 'monetisation') of the deficit does not mean the government is getting free money from the RBI.
- It has to be worked out through the combined balance sheet of the government and the RBI.
- In that case, it will turn out that the government gets it not free, but in heavily subsidised manner.
- That subsidy is forced out of the banks.
- And, as in the case of all invisible subsidies, banks do not even visibly know.
- In the other way, now, the RBI is monetising the deficit indirectly by buying government bonds through open market operations (OMOs).
- Notably, both monetisation and OMOs involve printing of money by the RBI.
- But there are important differences between the two options that make

shifting over to monetisation a risky decision.

How is OMO better to direct monetisation?

- 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 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.
- That can be a more serious problem than it seems.
- More importantly, India is inflation prone unlike many other economies.
- Notably, after the global financial crisis when inflation "died" everywhere, India was hit with a high and stubborn inflation period.
- As is said by some, the RBI back then failed to tighten policy at the right time.
- But since then, India has embraced a monetary policy framework.
- The RBI has indeed earned credibility for delivering on inflation within the target in this period.
- Now, forsaking that credibility can be costly, with wider implications for the economy both in the short- and long-terms.
- If, despite these, the government decides to go ahead, markets will fear that the constraints on fiscal policy are being abandoned.
- They may see the government as planning to solve its fiscal problems by inflating away its debt.
- If that occurs, yields on government bonds will shoot up, which is the opposite of what is sought to be achieved.
- If in fact bond yields shoot up in real terms, there might be a case for monetisation, strictly as a one-time measure. India has not reached that point yet.
- In sum, monetisation has few advantages but it carries a large cost in credibility.

Source: Indian Express, Economic Times