Monetised Deficit

September 11, 2020

In a recent interview, the finance minister said that she is keeping her options open on monetisation of the deficit by the Reserve Bank of India (RBI). How the government and the RBI decide on this will have significant implications for India's economic prospects in the short-term, and indeed in the long-term.

Monetisation of Deficit

- Monetised deficit is the **monetary support the Reserve Bank of India (RBI) extends to the Centre** as part of the government's borrowing programme.
- It refers to the **purchase of government bonds directly from the primary market** by the central bank to finance the spending needs of the government.
- The exercise leads to an increase in total money supply in the system, and hence **inflation**, as RBI creates fresh money to purchase the bonds.
- Monetisation of the deficit does not mean the government is getting free money from the RBI. If one works through the combined balance sheet of the government and the RBI, **the government is rather getting heavily subsidised money.**
- It is not as if the RBI is not monetising the deficit now; it is doing so, but indirectly by buying government bonds in the secondary market through what are called **open market operations (OMOs).**

Historical Context

- In the pre-reform era, the RBI used to **directly monetise the government's deficit** almost automatically. That **practice ended in 1997** with a landmark agreement between the government and the RBI.
- It was agreed that henceforth, the **RBI would operate**

only in the secondary market through the OMO route. The implied understanding also was that the RBI would use the OMO route **not so much to support government borrowing but as a liquidity instrument** to manage the balance between the policy objectives of supporting growth, checking inflation and preserving financial stability.

- Since the government started borrowing in the open market, **interest rates went up which incentivised saving** and thereby spurred investment and growth.
- Also, the interest rate that the government commanded in the open market acted as a **critical market signal of fiscal sustainability.**
- Importantly, the agreement **shifted control over money supply**, and hence over inflation, **from the government's fiscal policy to the RBI's monetary policy.**
- However, the Fiscal Responsibility and Budget Management Act as amended in 2017 contains an **escape clause** which permits monetisation of the deficit under special circumstances.
- The case is made on the grounds that there just aren't enough savings in the economy to finance government borrowing of such a large size. Bond yields would spike so high that financial stability will be threatened. The RBI must therefore step in and finance the government directly to prevent this from happening.

Difference Between OMO and Monetisation

- Both monetisation and OMOs involve expansion of money supply which can potentially stoke inflation. However, the inflation risk they carry is different.
- OMOs are a monetary policy tool with the **RBI in the driver's seat**, deciding on how much liquidity to inject and when.
- In contrast, monetisation is, and is seen, as a way of financing the fiscal deficit with the quantum and timing

of money supply determined by the government's borrowing rather than the RBI's monetary policy.

- If RBI is seen as losing control over monetary policy, it will raise concerns about inflation.
- Further, the **markets will fear that the constraints on fiscal policy are being abandoned** and that the government is planning to solve its fiscal problems by inflating away its debt.
- If that occurs, yields on government bonds will shoot up, the opposite of what is sought to be achieved.