WHO'S AFRAID OF MONETISATION OF THE DEFICIT?

The shrill clamour against it is based on misconceptions; fears of inflation lack substance

As the government began to wrestle with the severe downturn caused by the novel coronavirus pandemic, some economic pundits urged the government to go out and spend without worrying about the increase in public debt. They said the rating agencies would understand that these are unusual times. If they did not and chose to downgrade India, we should not lose too much sleep over it.

Rating and fundamentals

Well, the decision of the rating agency, Moody's, to downgrade India from Baa2 to Baa3 should come as a rude awakening. The present rating is just one notch above the 'junk' category. Moody's has also retained its negative outlook on India, which suggests that a further downgrade is more likely than an upgrade.

The rationale given by Moody's should especially make people sit up. The downgrade, Moody's says, has not factored in the economic impact of the pandemic. It has to do with India's fundamentals before the onset of the pandemic and the extended lockdown with which India responded. The message should be clear enough. Any further deterioration in the fundamentals from now on will push India into 'junk' status.

We should not lose sleep over a further downgrade and simply borrow our way out of trouble? Anybody who thinks so is living in cloud cuckoo land. Whatever the failings of the agencies, in the imperfect world of global finance that we live in, their ratings do carry weight. Institutional investors are largely bound by covenants that require them to exit an economy that falls below investment grade.

If India is downgraded to junk status, foreign institutional investors, or FIIs, will flee in droves. The stock and bond markets will take a severe beating. The rupee will depreciate hugely and the central bank will have its hands full trying to stave off a foreign exchange crisis. That is the last thing we need at the moment.

Work towards an upgrade

We have to put our best foot forward now to prevent a downgrade and bring about an upgrade instead. To do so, we need to note the key concerns that Moody's has cited in effecting the present downgrade to our rating: slowing growth, rising debt and financial sector weakness. These concerns are legitimate.

Many economists as also the Reserve Bank of India (RBI) expect India's economy to shrink in FY 2020-21. The combined fiscal deficit of the Centre and the States is expected to be in the region of 12% of GDP. Moody's expects India's public debt to GDP ratio to rise from 72% of GDP to 84% of GDP in 2020-21. The banking sector had non-performing assets of over 9% of advances before the onset of the pandemic. Weak growth and rising bankruptcies will increase stress in the banking sector.

The government's focus thus far has been on reassuring the financial markets that the fisc will not spin out of control. It has kept the 'discretionary fiscal stimulus' down to 1% of GDP, a figure that is most modest in relation to that of many other economies, especially developed economies. ('Discretionary fiscal stimulus' refers to an increase in the fiscal deficit caused by government policy as distinct from an increase caused by slowing growth, the latter being called an 'automatic stabiliser').

Keeping the fiscal deficit on a leash addresses the concerns of rating agencies about a rise in the public debt to GDP ratio. But it does little to address their concerns about growth. The debt to GDP ratio will worsen and financial stress will accentuate if growth fails to recover quickly enough. The government's stimulus package relies heavily on the banking system to shore up growth. But there is only so much banks can do. More government spending is required, especially for infrastructure.

Clearing misapprehensions

We need to increase the discretionary fiscal stimulus without increasing public debt. The answer is monetisation of the deficit, that is, the central bank providing funds to the government. Mention 'monetisation of deficit' and many economic pundits will cower in terror. These fears are based on misconceptions about monetisation of the deficit and its effects.

A common misconception is that it involves 'printing notes'. One image that leaps to mind is the printing presses of central banks cranking out notes with abandon. But that is not how central banks fund the government. The central bank typically funds the government by buying Treasury bills. As proponents of what is called Modern Monetary Theory point out, even that is not required. The central bank could simply credit the Treasury's account with itself through an electronic accounting entry.

When the government spends the extra funds that have come into its account, there is an increase in 'Base money', that is, currency plus banks' reserves. So, yes, monetisation results in an expansion of money supply. But that is not the same as printing currency notes.

What could be the objection to such an expansion in money supply? It could be that the expansion is inflationary. This objection has little substance in a situation where aggregate demand has fallen sharply and there is an increase in unemployment. In such a situation, monetisation of the deficit is more likely to raise actual output closer to potential output without any great increase in inflation.

Exponents of the MMT make a more striking point. They say there is nothing particularly virtuous about the government incurring expenditure and issuing bonds to banks instead of issuing these to the central bank. The expansion in base money and hence in money supply is the same in either route. (The precise sequence of central bank transactions in these two cases and the identity in outcomes is shown in Macroeconomics by Mitchell, Wray and Watts, three economists who are among the leading exponents of MMT). The preference for private debt is voluntary. MMT exponents say it has more to do with an ideological preference for limiting government expenditure. But that is a debate for another day.

Central banks worldwide have resorted to massive purchases of government bonds in the secondary market in recent years, with the RBI joining the party of late. These are carried out under Open Market Operations (OMO). The impact on money supply is the same whether the central bank acquires government bonds in the secondary market or directly from the Treasury. So why the shrill clamour against monetisation of public debt?

About inflation control :

OMO is said to be a lesser evil than direct monetisation because the former is a 'temporary' expansion in the central bank's balance sheet whereas the latter is 'permanent'. But we know that even so-called 'temporary' expansions can last for long periods with identical effects on inflation. What matters, therefore, is not whether the central bank's balance sheet expansion is temporary or permanent but how it impacts inflation. As long as inflation is kept under control, it is hard to argue against monetisation of the deficit in a situation such as the one we are now confronted with.

We now have a way out of the constraints imposed by sovereign ratings. The government must confine itself to the additional borrowing of ₹4.2 trillion which it has announced. Further discretionary fiscal stimulus must happen through monetisation of the deficit. That way, the debt to GDP ratio can be kept under control while also addressing concerns about growth. The rating agencies should be worrying not about monetisation per se but about its impact on inflation. As long as inflation is kept under control, they should not have concerns — and we need not lose sleep over a possible downgrade.

Meanings of Difficult Words :

- **monetisation** (noun) – In general, it is the process of converting something (e.g. an asset) into money.
- **deficit** (noun) – shortfall, deficiency, shortage.
- **shrill** (adjective) – high-pitched, strident, loud, piercing.
- **clamour** (noun) – protest, complaint, outcry/ commotion.
- **misconception** (noun) – misunderstanding, mistake, error, illusion.
- **inflation** (noun) – simply meaning "cost of living"; increase of price level of goods & services and vice versa decrease of currency value.
- **lack** (verb) – be in need of, need, require, be short of.
- **substance** (noun) – significant subject, important matter/content, valid message.
- **wrestle** with (verb) – grapple, fight, struggle/battle.
- **downturn** (noun) – decline, setback, blow/upset (in economic activity).
- **pundit** (noun) – expert, specialist, consultant, adviser.
- **public debt** (noun) – In the Indian context, public debt includes the total liabilities of the Union government that have to be paid from the Consolidated Fund of India. Public debt is the total amount, including total liabilities, borrowed by the government to meet its development budget. It has to be paid from the Consolidated Fund of India.
- **downgrade** (verb) – reduce (in status/rank/ importance).
- **lose sleep over** (phrase) – to worry about something so much.
- **credit rating** (noun) – an assessment of the probability of default on payment of interest and principal on a debt instrument (Courtesy: **www.sebi.gov.in)**.
- **credit rating agency (CRA)** (noun) – a credit rating agency is an entity which assesses the ability and willingness of the issuer company for

timely payment of interest and principal on a debt instrument (Courtesy: **www.sebi.gov.in)**

- **Baa3 credit rating** (noun) – A credit rating used by Moody's credit agency for long-term bonds and some other investments. A Baa3 rating represents a relatively low-risk bond or investment. However, Baa3 is at the bottom of investment grade bond ratings, being only one grade above junk bond ratings. It is a subdivision of a Baa rating.
- **rude** (adjective) – abrupt, sudden, sharp; disagreeable, harsh.
- **awakening** (noun) – understanding, insight, awareness, learning.
- **notch** (noun) – degree, step, level, grade. "a notch or two" means to "one or two step/ level/ degree".
- **junk bonds** (noun) – bonds that are not rated as investment-grade bonds are known as high yield bonds or junk bonds. In finance, a high-yield bond/junk bond is a bond that is rated below investment grade.
- **outlook** (noun) – viewpoint, opinion, perspective.
- **downgrade** (noun) – reduction (in status/rank/ importance); downward.
- **rationale** (noun) – reason, basis, logic, principle.
- **sit up** (phrasal verb) – to start paying attention (quickly).
- **factor in** (phrasal verb) – include or add as a factor/point when making a decision.
- **have to do with** (phrase) – be connected with someone/something.
- **onset** (noun) – start, beginning, arrival.
- **deterioration** (noun) – decline, collapse/failure degradation/breakdown.
- **way out** (noun) – solution, answer; escaping route (for a bad situation).
- **cloud cuckoo land** (noun) – daydream, pipe dream, flight of fancy, fantasy.
- **failing** (noun) – shortcoming, deficiency, inadequacy.
- **imperfect** (adjective) – defective, faulty, deficient.
- **weight** (noun) – influence, force, importance, significance.
- **bound by** (adjective) – obliged, compelled, required, constrained, duty-bound.
- **covenant** (noun) – contract, agreement, deal.
- **flee** (verb) – run away, run off, take flight, escape.
- **drove** (noun) – mass, crowd, multitude, throng, mob.
- **stock market** (noun) – equity market, share market, a stock exchange. It is where traders buy and sell shares of companies on a public exchange.
- **bond market** (noun) – debt market; the market where debt instruments (like bonds (government or corporate) and mortgages) are traded.
- **take a beating** (phrase) – suffer damage.
- **depreciate** (verb) – decrease, decline, lose value.
- **have one's hands full** (phrase) – occupied in, engaged in, involved in.
- **stave off** (phrasal verb) – avert, prevent, avoid, rule out.
- **foreign exchange reserve** or **forex** (noun) – Foreign exchange. Forex (exchange) reserves are the amounts of assets /money in foreign currencies that a country has in its central bank (in India, it is Reserve bank of India).
- **put one's best foot forward** (phrase) – start/ begin something with a lot of effort and will power.
- **bring about** (phrasal verb) – cause, create, produce, give rise to.
- **legitimate** (adjective) – valid, reasonable, reliable.
- **shrink** (verb) – lessen, reduce, decrease.
- **fiscal deficit** (noun) – the difference between total expenditure and total income of the government.
- **Gross domestic product (GDP)** (noun) – a measure of economic activity in a country. It is the total value of a country's annual output of goods and service.
- **non-performing assets (NPAs)** (noun) – bad loans, troubled accounts, stressed loans; an account where principal and/or interest remains overdue for a period of time.
- **advances** (noun) – the funds provided by the banks to the business to fulfill working capital requirement which are to be payable within short period of time (e.g. one year). (Loans refer to a debt provided by a financial institution for a particular period).
- **bankruptcy** (noun) – legal state of insolvency. An individual or organisation is declared bankrupt if a court judges that the party involved can no longer meet debt payments to creditors. it is defined as the outcome of a legal procedure.
- **insolvency** (noun) – a condition in which the financial difficulties of an individual or organisation are such it is unable to pay its debts.
- **stress** (noun) – (financial) hardship, burden; trouble, difficulty.
- **thus far** (phrase) – until now, till date.
- **fisc** (noun) – treasury, exchequer.
- **fiscal stimulus** (noun) – Government measures, normally involving increased public spending and lower taxation, aimed at giving a positive jolt to economic activity.

- **spin out of control** (phrase) – move in an uncontrolled way.
- **modest** (adjective) – moderate, tolerable, acceptable, small.
- **distinct** (adjective) – well defined, different, unconnected.
- **discretionary fiscal stimulus** (noun) – it refers to an increase in the fiscal deficit caused by government policy.
- **automatic stabiliser** (noun) – it refers to an increase in the fiscal deficit caused by slowing growth.
- **leash** (noun) – control, restraint, check/curb.
- **address** (verb) – tackle, deal with, attend to, try to sort out.
- **accentuate** (verb) – highlight, underline, focus attention on.
- **stimulus package (**noun) – an attempt by the government to boost economic growth and save their country from a financial crisis by involving tax cuts, lowering interest rates and increasing government spending.
- **rely on** (phrasal verb) – depend on; resort to, have recourse to.
- **shore up** (phrasal verb) – support, assist, prop up (with some fund/finance to stop declining).
- **misapprehension** (noun) – mistake, error, misinterpretation, illusion.
- **cower** (verb) – shrink, pull back, draw back, recoil (in fear).
- **leap** (verb) – jump, rush, reach/come hurriedly.
- **crank out** (phrasal verb) – produce something (in large numbers) automatically & quickly.
- **abandon** (noun) – lack of restraint/control.
- **Treasury bills** (noun) – when the government goes to the financial market to raise money, it does so by issuing two types of debt instruments — treasury bills and government bonds. Treasury bills are issued when the government needs money for a short period. These bills are issued only by the central government, and the interest on them is determined by market forces.
- **proponent** (noun) – advocate, supporter, upholder/ promoter.
- **Modern Monetary Theory (MMT)** (noun) – This theory says that governments can and ought to simply print their way out of a recession.
- **point out** (phrasal verb) – identify, recognize, draw attention to, mention.
- **base money** (noun) – it consists of both the total banknotes and coins in circulation and sight deposits held at central banks on behalf of commercial banks. (sight deposits are deposits which can be withdrawn from a bank either without notice, or after a very short notice period).
- **bank reserve** (noun) – the cash minimums that must be kept on hand by financial institutions in order to meet central bank requirements.
- **objection** (noun) – opposition, disapproval, disagreement.
- **inflationary** (adjective) – tending to cause monetary inflation.
- **aggregate demand** (AD) (noun) – it is the total demand for final goods and services in an economy at a given time.
- **exponent** (noun) – advocate, supporter, proponent.
- **striking** (adjective) – unmistakable, distinctive, strong.
- **virtuous** (adjective) – righteous, morally correct, ethical, upright.
- **government expenditure or public spending** (noun) – money spent by the government.
- **sequence** (noun) – succession, course, series, progression.
- **macroeconomics** (noun) – the branch of economics concerned with large-scale factors (interest rates/national productivity).
- **ideological** (adjective) – relating to a system of ideas.
- **resort to** (verb) – use, utilize, turn to, have recourse to.
- **of late** (phrase) – recently, lately, in recent times.
- **carry out** (phrasal verb) – conduct, perform, execute.
- **open market operation (OMO)** (noun) – the buying and selling of government securities in the open market by the central Bank in order to increase/decrease the money supply in the market.
- **balance sheet** (noun) – a statement that shows the financial condition of a company at a particular point in time.
- **whereas** (conjunction) – in conflict/comparison with the fact that.
- **confront** (verb) – deal with, tackle, address, face up to.
- **constraint** (noun) – restriction, limitation, restraint.
- **sovereign** (adjective) – independent, self-governing; having independent authority and the right to govern itself.
- **sovereign (credit) rating** (noun) – it indicates the risk level of the investing environment of a country and is used by investors when looking to invest in particular jurisdictions, and also takes into account political risk.
- **per se** (adverb) – (Latin) in itself, of itself, as such, intrinsically.