Direct Monetisation

Why in News

The government's (both centre and state) fiscal deficit is expected to **shoot up to around 15% of Gross Domestic Product (GDP)** when the **permissible limit is only 6%** according to **Fiscal Responsibility and Budget Management (FRBM)** obligations.

The **possibility of direct monetisation** to alleviate the stress is being explored.

Key points

- **Fiscal Deficit :**
    - Fiscal deficit is the **total amount of borrowings required** to bridge the gap between government's spending and revenues.
    - The borrowings can be from the internal sources (public, commercial banks, central bank etc.) or the external sources (foreign governments, international organisations etc.).
    - At this time, for the government to borrow the money, the market should have it as savings.
        - Data show that savings of **domestic households** have been faltering and are **not enough to fund the government's existing borrowing needs.**
        - **Foreign investors have been pulling out** and moving to "safer" economies like the US, and are unwilling to lend in times of such uncertainty.
- **Ideal limit for government debt :**
    - According to economists developing economies like India **should not have debt higher than 80%-90% of the GDP.** At present, it is around 70% of GDP in India.
    - The government should commit to a predetermined amount of **additional borrowing and to reversing the action** once the crisis (Covid-19 outbreak) is over.

- **Direct monetisation (borrowing from the RBI):**
    - In direct monetisation, the government asks RBI to **print new currency in return for new bonds** that the government gives to the RBI.
    - **In lieu of printing new cash,** which is a liability for the RBI (since, every currency note has the RBI Governor promising to pay the bearer the designated sum of rupees), it gets government bonds, which are an asset for the RBI since such bonds carry **the government's promise to pay back the designated sum at a specified date.**
    - Now, the **government would have the cash to spend and alleviate the stress** in the economy via direct benefit transfers to the poor or starting construction of a hospital or providing wage subsidy to workers of small and medium enterprises etc.
    - This is different from the **"indirect" monetisation** that RBI does when it conducts the **Open Market Operations (OMOs) and/ or purchases bonds** in the secondary market.
- **Direct Monetisation by other countries in the wake of Covid-19:**
    In the United Kingdom (UK) on April 9, 2020 the Bank of England extended direct monetisation facility to the UK government.
- **Problems with direct monetisation of government deficit:**
    - **High Inflation**
        - Ideally, the direct monetisation provides an opportunity for the government to **boost overall demand at the time when private demand has fallen.**
        - Thus, it **fuels inflation.** A little increase in inflation is healthy as it encourages business activity.
        - However, **higher inflation and higher government debt** provide grounds for **macroeconomic instability.**
    - **Inefficient Spending:** The governments are considered **inefficient and corrupt** in their spending choices— for example, whom to help and to what extent.
    - **Crisis in the Past:** Earlier, the direct monetisation led to the **balance of payments crisis** in 1991, and a near-crisis in 2013.
        - Until 1997, the RBI "automatically" monetised the government's deficit.
        - In 1994, Manmohan Singh (then Finance Minister) and C Rangarajan, then RBI Governor, decided to end this facility by 1997.

Source: IE