Direct Monetisation for Funding Deficit: SBI

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Why in News

Recently, a report by the **State Bank of India (SBI)** has recommended **direct monetisation** as a possible way of funding the Centre's deficit at lower rates, without increasing inflation and affecting debt sustainability.

Key Points

- **Direct Monetisation:**
    - It simply means that the **Reserve Bank of India (RBI)** directly funds the Central government's deficit against government bonds or securities.
    - Until 1997, the government used to sell securities directly to the RBI. This allowed the government to technically **print equivalent amounts of currency to meet its budget deficit.**
    - However, this practice was **stopped over its inflationary impact** and in favour of fiscal prudence.
    - 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.

- **Increasing Debt:**
  - Most agencies expect **India's Gross Domestic Product (GDP) to contract by more than 5% in FY 2020-21** as a result of slump in economic activity. This has **also led to reduction in revenues of the government.**
    This means the **government will run short of its revenue targets,** and will be forced to raise debt.
  - Further, SBI noted that the GDP collapse is pushing up the debt-to-GDP ratio by at least 4%.
    - India's debt-to-GDP ratio is projected to rise to around Rs. 170 lakh crore or 87.6% of GDP in FY21, from Rs 146.9 lakh crore (72.2% of GDP) in FY20.
    - The higher debt-to-GDP ratio means, less probability of the country to pay back its debt and the higher its risk of default.
- **Recommendations of the SBI Report:**
  - The report argued that the **Fiscal Responsibility and Budget Management (FRBM) Act, 2003** also allows direct monetisation of deficit in certain exceptional circumstances, the **Covid-19 pandemic** being one such.
    It expects this not to be inflationary, given the stagnant demand in the country.
  - The report argued that **bringing growth back is more important to debt sustainability as compared to fiscal conservatism** (which involves lower levels of public spending, lower taxes and lower government debt).
    - As the current level of foreign exchange reserves are sufficient to meet any external debt obligations. Also, since most of the debt is domestically owned, the debt servicing of the internal debt is also not an issue.
    - The real challenge is the contraction of economic growth, which can turn **interest rate-growth differential into a positive trajectory.**
      Interest rate - growth differential is a key metric watched by agencies to gauge debt sustainability.
    - A **negative interest rate-growth** differential, which denotes growth is higher than interest rate on debt, is important from a sustainability perspective, as higher growth means government's revenue expansion will outstrip any spike in debt repayment.

Source: IE