Financing the Fiscal Deficit

Why in News

India, being one the hardest hit major economy due to **Covid-19**, faces the challenge of managing its fiscal deficit.

- **Borrowing more and monetizing the deficit** are the options being considered by the government and **Reserve Bank of India (RBI)** to finance the fiscal deficit.

Key Points

- **State of Indian Economy:**
  - As per the official data, the **Centre's fiscal deficit** for the first three months of fiscal 2020-21 (April-June) was Rs. 6.62 lakh crore, which is 83% of the budgeted target for the whole year.
    - As per the economists, the fiscal deficit may end up as high as 8% of the Gross Domestic Product (GDP), far exceeding the budget's goal of 3.5%.
  - The **GDP contracted by 23.9% in the first** (April-June) quarter of 2020 compared to the same period (April-June) in 2019.
  - The **manufacturing sector is also contracting,** as per the recent IHS Markit India Manufacturing **Purchasing Managers' Index (PMI).**
  - The **output of eight core industries** contracted for the **fourth consecutive month - shrinking by 15%** in June 2020.
  - The **Financial Stability Report** from RBI also shows an increase in bad loans and Non-Performing Assets (NPA).

Methods of Bridging the Fiscal Deficit

- **Borrowing from the market:**
  - The government has already raised its gross market borrowing target for the current financial year by **more than 50%,** owing to the pandemic.
  - **Disadvantage:**
    - **High Debt:** An increased **borrowing** programme means that the public **debt** will go up.
    - **Higher Interest Rates:** Higher borrowing can **push up interest rates** because markets are nervous about the government's ability to repay.
    - **Increase in Taxes:** It may also necessitate an increase in taxes. This may burden the common people and also lead to less spending and saving by the public, leading to a stalled market.
    - **Crowding out:** When the government borrows from the private sector by selling bonds, the private sector is left with less money to spend and invest. Therefore, although government spending increases, private sector spending falls.
- **Monetisation of the Deficit:**

- Monetising deficit means RBI purchases government bonds in the primary market and **prints more money to finance the debt.**
- This is resorted to only when the government **cannot borrow from the market** (Banks and other Financial Institutions like LIC).
- The money printed by the RBI is called **high powered money or reserve money or monetary base.**
- RBI also conducts **indirect monetization of deficit** through **Open Market Operations (OMOs).**
    - OMOs are market operations conducted by RBI by way of **sale/purchase of government securities to/from the market** with an objective to **adjust the rupee liquidity conditions** in the market on a durable basis.
    - Recently, RBI **decided to infuse Rs. 10,000 crore liquidity in the banking system** by buying government securities through OMOs.
    - Purchase of Government securities by the RBI helps in increasing the supply of the money in the market and with banks. It helps to stabilize the market economy and generates credibility in the investors.
    - It is different from monetization as it is controlled by RBI instead of the government as it is not as inflationary as deficit monetization.
- **Advantages:**
    - It has **helped in the economic development** of India as our domestic savings were less than 9% of GDP and the capacity to raise loans was also limited during the early 1950s, constraining the welfare activities of the government.
- **Disadvantages:**
    - Deficit financing is **inflationary** and is bad for the health of the central bank.
    - It may **push up interest rates** and thus make it even more difficult for the government to service the loan.
    - It also poses threat to the **financial stability** of the economy.

FRBM and Monetizing Deficits

- Monetisation of deficit was in practice in India till 1997, whereby the central bank automatically monetised government deficit through the issuance of ad-hoc **treasury bills.**
- **Two agreements were signed between the government and RBI in 1994 and 1997** to completely phase out funding through ad-hoc treasury bills.
- With the enactment of Fiscal Responsibility and Budget Management **(FRBM) Act, 2003,** it was totally barred.
- However, the FRBM Act Amendment, 2018 contains an escape clause which permits monetisation of the deficit under special circumstances.
    - **Escape clause** generally refers to a contract provision that specifies the conditions under which a party can be freed from an obligation.
    - Escape clauses provide **flexibility to governments to overshoot fiscal deficit targets** in times of need, enabling them to respond to economic shocks.
    - The escape clause under the FRBM Act details a set of events in which the Central government can deviate from fiscal deficit targets. These include:
        - Overriding considerations of national security, acts of war, and calamities of national proportion and collapse of agriculture severely affecting farm output and incomes.
        - Far-reaching structural reforms in the economy with unanticipated fiscal implications.
        - A sharp decline in real output growth of at least 3% points below the average for the previous four quarters.

Way Forward

- Since the RBI has already taken up Open Market Operations and adopted a **monetary policy framework** to insert liquidity into the market, monetizing the deficit will only cost the government the credibility of the market and put inflationary pressure.
- Given the inflation-prone nature of Indian economy, monetization of deficit should only be considered as a last resort. Even if it is adopted, the primary challenge will be to communicate and ensure that this is a one-off pandemic-induced arrangement and not a recurrent financing line.

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