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Demand-Inducing Stimulus as Covid-19 Response: A Case for Debt Monetisation

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ABSTRACT As India reels from the economic fallout of Covid-19 despite the announcement of a relief package, calls for a more refined and demand-inducing stimulus have emerged. However, the bleak state of the government's coffers has left limited fiscal space to act. This brief explains the plausibility of financing a demand-inducing stimulus using debt monetisation as a one-time policy measure. Outlining the criticisms against such proposals and how these could be managed, the brief calls for a framework for monetising state deficit. It argues that debt monetisation is the most appropriate way forward, given the government's limited options amidst the urgency of managing the pandemic and stabilising the economy.

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INTRODUCTION

India's growth rate is projected to be negative for the present fiscal year,[1] amidst a pandemic of a virus that has infected over six million Indians so far.[2] The nationwide lockdown, as a response to contain the spread of the virus, led to soaring unemployment, the abrupt halt of supply,[3] and plummeting demand,[4] making conditions worse for an already weak economy.[5] While the supply shocks eased marginally as the lockdown was lifted beginning in June,[6] current forecasts suggest continued weak demand in the country.[7] Analysts project that FY21 could be a year of deep recession for India.[8] This will likely reverse the considerable progress that India has made in various development parameters including poverty eradication,[9] education,[10,11] nutrition,[12] and women empowerment.[13] The imperative is to quickly nurse the country back to health, and such goal requires a huge fiscal stimulus.

The INR 20-trillion Atmanirbhar Bharat stimulus package announced in May, amounting to 10 percent of India's GDP,[14] while welcome, focuses mostly on monetary policy tools which form only contingent liabilities.[a] The actual fiscal cost to the government was a little over one percent of the GDP, and has had little effect on demand.[15] The government could not afford a bigger package owing to its limited fiscal space despite borrowing and aid.[16] Such limited spending has led to many issues unaddressed,[17] including in particular, the demand problem.[18, 19] If the government was to decide to spend more for economic recovery, the question is where the money would come from.

MONETARY POLICY INSTRUMENTS

The Reserve Bank of India (RBI) has taken steps to address the huge liquidity crunch: it lowered the repo rate, used Targeted Long-Term Repo Operations 2.0 (TLTRO), engaged in bigger and more targeted lending, imposed a moratorium on loan payments, and extended those moratoriums.[20] These measures are considered innovative for the RBI, as it acknowledged the devastating economic fallout of the Covid-19 pandemic and therefore the need to ensure a smooth flow of money to the public via the banking system.[21] The Atmanirbhar Bharat package further emphasised on such measures to render relief.

However, easing lending conditions and providing more loans, does not imply provision of credit to the neediest. It is still up to the banks to lend out the money, and to the firms and entities to want to borrow that money.[22]

Upon identifying that the massive Non-Profit Assets (NPAs) sitting with banks

a Contingent Liabilities are legal commitments that governments must make payments for only if certain events occur. Thus, their fiscal cost is valid only when they become due.

could make them risk-averse to lending to smaller and more vulnerable companies, the RBI rolled out TLTRO 2.0 to ensure a smoother and more targeted flow of credit to these sectors. However, out of the INR 250 billion offered in the TLTRO 2.0 auction, the RBI received bids worth only INR 128.5 billion.[23] Such subdued response from the banks indicated their lack of willingness to lend to NBFCs (Non-Banking Financial Corporations) and MFIs (Micro Finance Institutions), in turn weakening the RBI's efforts at pumping liquidity to help these vulnerable sectors.[24]

Another reason for the slow provision of credit is the poor credit demand scenario in the country.[25] Despite recent revival, loan growth has been sluggish at just 5.5 percent year-on-year, while deposits are soaring at 10-11 percent y-o-y.[26] This is explained partly by the banks' aversion to high levels of lending exposure, and also by the slowdown in enterprise (especially in the MSME sector) due to inadequate demand.[27]

This suggests that while it would be crucial to offer the possibility of "easy" money to revamp the economy, it can only work when India simultaneously solves the problem of inadequate demand. Solely depending on monetary policy would not be enough; what is required is a combination of fiscal and monetary policy tools. While fiscal steps have been taken (mostly through Pradhan Mantri Garib Kalyan Yojna or PMGKY), these have been largely inadequate.[28] Thus, fiscal policy measures need to be implemented in parallel with monetary policy tools. Only when accompanied by a proportionate increase in government expenditure will RBI's efforts fructify.

The question then is—Where is the money?

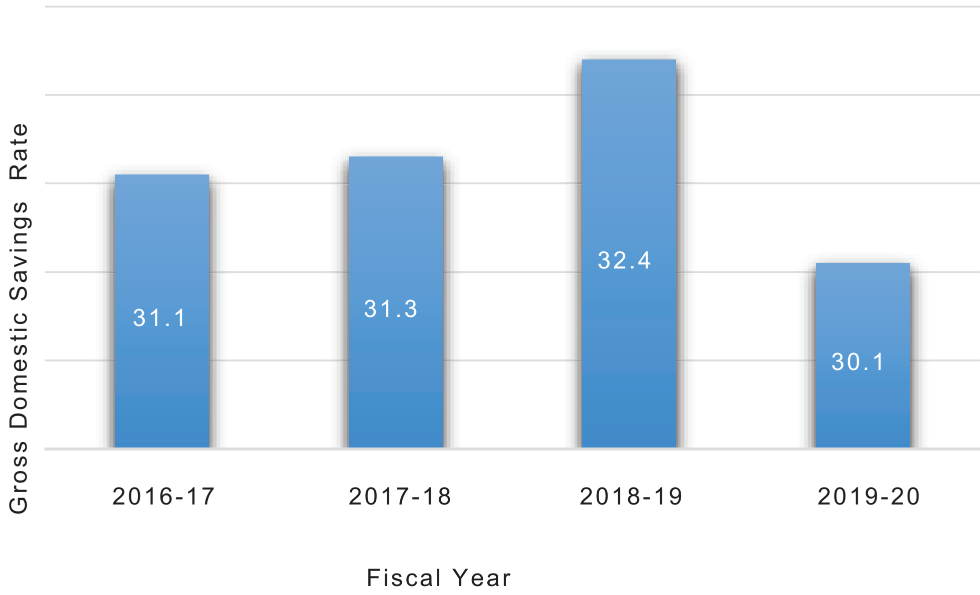
BORROWING FOR STIMULUS

A crisis the degree of the one presently facing India, requires an effective stimulus package. From past experience, borrowing from the market would have been enough for the government to finance such a package. At present, however, there are various concerns over domestic borrowing.

Even before the current crisis, household financial savings in India were already significantly low and faltering further, with data indicating that savings of domestic households[b] were barely enough to fund the government's existing borrowing needs.[29] Furthermore, households and firms, too, need to borrow in the present circumstances to tide through the difficult times. The many takers of the falling household savings imply that even if the government would want to borrow domestically, the funding available would be insufficient.

b Government borrowing is not from the entire stock of savings, but from the household financial savings, because only the household segment is a net saver, and all other segments are net borrowers.

Figure 1: Gross Domestic Savings Rate



Source: CEIC Data

Furthermore, the ability of the government to pay back on time is also a concern, given falling revenues across the country. The revenue receipts for the Union government for fiscal year 2019-20 was estimated at INR 19.63 trillion, although it was later revised to INR 18.50 trillion. The provisional estimates from RBI's latest figures is at a mere INR 16.82 trillion.[30]

To be sure, the pre-Covid economy was already showing signs of weakness and recording lower revenues. With the imposition of the prolonged, nationwide lockdown and the consequent slowdown of economic activity, the revenues further dropped. Indeed, data from Trading Economics and the Comptroller and Auditor General's office (CAG) show that the Union government recorded revenues of only INR 275.5 billion during the month of April 2020.[31] Furthermore, the shortfall in GST revenue has been estimated at INR 2.35 trillion.[32]

With the government recording low revenues, creditors have become wary and risk-averse over the possibility of government defaulting on loans. Such high risk to lend, coupled with the inadequate supply of funds to borrow domestically, led to steep market interest rates. When Kerala, for example, borrowed for its fiscal package of INR 200 billion in early April, it faced interest rates as high as nine percent.[33]

With RBI's intervention, the yield has fallen significantly, and market interest rates have started to decline to a little over six percent. However, sovereign bonds remained continually unsold in RBI auctions,[34] showing that its efforts to control yields has led to the market preferring corporate bonds over government bonds—a behaviour that is not normally observed.[35] If government borrowings continue to expand, there is every reason to suppose that yields will go up once again.

External Borrowing

Reliance on external debt is a possibility, but should be limited to a small proportion of the GDP. Undertaking external debt usually implies taking a loan in a foreign currency, which exposes the borrower, in this case the Indian government, to currency risk. An unexpected fall in the rupee value, for instance, would mean that more rupees should be paid, in addition to the interest that is accrued, to settle the loan.[36] As former Finance Minister Arun Jaitley once emphasised on domestically originated public debt:[37] "Public debt is predominantly of domestic origin and denominated in domestic currency, insulating the debt portfolio from currency risk."

Many Latin American countries learned the lesson the hard way in the 1970s. Their external debt ballooned to large proportions of their GDPs, and they were left unable to pay their dollar-denominated loans and suffered a severe financial crisis.[38]

For India, as things are, the country is already facing extremely high levels of debt-to-GDP ratios.[c] If in such a scenario, India undertakes additional external debt at high interest rates,[d] servicing such debt becomes extremely costly and could raise questions over India's ability to sustain its debt. This could, as Fitch Ratings suggests, further strain India's sovereign ratings.[39] While at present, India has enough foreign exchange to service its external borrowing liabilities, the situation might change with a ratings downgrade that in turn could lead to increased interest rates.[e]

It cannot be overemphasised, therefore, that an extremely large external debt overrides its benefits and could put India under higher risk. This becomes particularly crucial as the Rupee has been consistently losing value over the US Dollar and is likely to remain weak.[40]

DEBT MONETISATION

A viable option that remains is fiscal infusion via debt monetisation: the government could print more money to finance a demand-inducing stimulus in the economy. The RBI could print more money and buy state government's bonds and permit the states to borrow from the RBI for long term at low rates of interest.

The RBI has taken steps to increase credit flow to the states (through increasing Ways and Means Advances limits accessible

c In FY20, the debt to GDP ratio was 72.2% - SBI Report

d Currently, Fitch Ratings for India are a -BBB, which is the lowest among countries in an investment grade.

e As international creditors would become even more risk-averse to lend to India.

to states by 30 percent[41]). However, it is imperative to provide cheap loans at rates of interest no more than the repo rate (which is four percent at present[42]) so that servicing loans does not become too costly for the states. A lower rate of interest to the states will ensure that they would have money to finance a fiscal stimulus large enough to counter the slowing economy. Meanwhile, the most affected are spared the severe consequences,[f] and the states are not caught in the trap of unsustainable debt.

It must be noted, however, that while the present unusual and difficult circumstances call for radical actions, debt monetisation should not become the default policy response of the government. The government must guarantee that only a certain amount of money (a portion of the fiscal stimulus) would be printed as the country battles the pandemic.

Necessity of a State-Based Fiscal Infusion

Fiscal decentralisation is crucial to ensuring a greater reach and effective support to the most vulnerable. First, debt management strategies of the Union government have recently devolved into creative ways to hide its true deficit—including pushing a significant part of its borrowing off-budget. These strategies have led to a lack of trust and credibility in the centre's fiscal position and moves. While implementation of any sort of monetisation will require restoring the Union government's integrity and public belief in the budget process, a policy device that monetises the state debt instead of the centre will assure higher level of credibility and transparency in the use of that debt and might work to bridge the current trust deficit between states and the centre.[43] Even in the past, state governments have been more responsive and fiscally conscious than the Union government.

Second, as noted by Former RBI Governor Urijit Patel, the centre has been running its fiscal policy through the public sector banks –essentially by giving out unsustainable levels of credit, and then bailing the banks out when required through recapitalisation—and in the process committing fiscal expenditure.[44] However, as mentioned earlier, the benefits of a bank-led fiscal policy accrue mainly to those who already have access to formal credit. Even the Jan-Dhan Accounts that contributed 0.4 billion Indians opening bank accounts and becoming financially connected,[45] are strained with inactivity (and therefore rendering financial credit still inaccessible for many.)[46] On the other hand, states through already developed grassroots mechanisms, can reach the most affected and respond correspondingly.

Third, given the shortfall in GST revenues which has led to the Union government's inability to pay the GST compensation to the states,[47] the states are

f Furthermore, this will be beneficial in providing subsidised and/or free vaccine as and when it launches.

facing a huge resource constraint since they now have to borrow the GST revenue that was legally due them. In such a case, there is little scope for a front-line response by the states against the continued ill-effects of Covid-19. This limited space allows for only marginal spending on providing the necessary social security benefits.

Finally, fiscal decentralisation also creates accountability and transparency with a possibility to establish liability in case of deficiencies.

Quantitative Easing

India would not be the first to take on a radical step of fiscal infusion amidst the pandemic. Central Banks in countries like the US, UK, Japan and even in developing countries like Indonesia, have opted for printing money to buy government bonds in the open market, so that the governments can incur huge emergency spending to counter the Covid-induced crisis.[48]

Some of these measures, however—wherein the central banks purchase bonds issued by the government in the open market through interest bearing reserves—come under Quantitative Easing.[49] The RBI, as per reports, had already been buying government bonds through primary market dealers[g] through open market operations.[50]

The difficulty, however, is that the issuance of debt by the government in the open market necessitates repayment of equal value of money in the future. Inability to pay back forces the central bank to roll over government debt, which effectively monetises the deficit.[51] The only way therefore that a government can attain fiscal funds without adding to its future liabilities is by increasing reserves without a corresponding surge in the future claims on revenue generated by the government. The only means to do so is debt monetisation.[52]

Not adding to future government liabilities is important for rapid economic growth when it is certain that under the present circumstances, additional finances would be used to raise healthcare, help MSMSEs, increase social security benefits, augment employment guarantee including, as many have proposed, urban employment guarantee. If the burden of the liabilities leads to forced debt monetisation, greater damage could be done to the economy and investor confidence than a planned and one-time use of monetisation as a fiscal option.

ISSUES ASSOCIATED WITH DEBT MONETISATION

Debt monetisation is not without concerns. The concept has many opponents, including former governors of the Reserve Bank. Dr. DV Subbarao, for one, has raised concerns, proposing that the Union government

g A primary market dealer basically buys bonds directly from the government, acting as a market maker, with the intention of selling the bonds to other financial firms must opt for debt monetisation, as a one-time measure, only if financing deficit at reasonable rates is no longer a possibility.[53] However, as mentioned earlier, with increased government borrowing under the present circumstances, interest rates are likely to go up, which given falling revenues, would make it difficult to pay back loans. This might lead to default. If on the other hand, the government does not spend enough to mitigate the economic fallout of the pandemic, it would lead to low economic activity and low recovery. This forms a vicious circle, where the poorest and marginalised will face a disproportionate brunt of the despair brought about by a weak economy.

A recent article by Dr. Manmohan Singh, former prime minister, also subscribed to using debt monetisation only as the last resort given the high institutional as well as intangible cost associated with the policy tool.[54] While the institutional costs of unchecked debt monetisation have been high in the past,[55] the unfortunate truth is that India has nearly exhausted its other options. With inadequate domestic funds, it would not be wise to depend extensively on external borrowings when the debt-to-GDP ratio is already high. This would only make it difficult to bear additional borrowings at higher interest rates.

Dr. Raghuram Rajan, former RBI governor, for his part, has called on the government not to dismiss measured debt monetisation as a policy measure, albeit, that it might in fact not do wonders for the country.[56] Another former RBI Governor, Dr. C. Rangarajan, however emphasised on the inevitability of monetising a part of the deficit as government's increased expenditure forces RBI borrowing.[57]

One thing that bars the process of monetising state debt in India, as recommended in the text here, is the Fiscal Responsibility and Budget Management (FRBM) Act of 2003.[58] The law was passed to ensure that states keep their fiscal deficit in check and do not indulge in frivolous spending. It might be necessary to amend the law to allow the government some means of mitigating Covid-19's impact.

While debates over the potential efficacy of debt monetisation remain, it is true that the concerns over this policy tool are valid. Such worries owe to four reasons, some of them having already been expressed by the experts referred to in this brief: inflation; increased fiscal deficit; negative effect on sovereign ratings; and decreased independence of RBI.

Inflation

The introduction of more money into the economy without proportionate increase in production capacities could lead to inflation. Food inflation could be an especially important concern for India if spending increases given supply shocks,[59] a concern that many analysts associate with debt monetisation.

It cannot be denied that inflationary pressures do continue to operate, and an increase in demand could lead to a rise in inflation. However, countering any such rise can be safely left to the central bank's mandate – which aims to target inflation via interest rate adjustment as it did recently when it refused to further cut interest rates to maintain the inflation rate.[60] Furthermore, fortunately for India, the Food Corporation of India (FCI) claims to have enough supply[61] to provide wage goods even free of cost to keep inflation at bay.

On the other hand, the production capacities in the non-food sectors are largely unutilised due to inadequate demand in the market. The chances of having "too much money chasing too few goods" are therefore minimal.[62] In such a scenario, debt monetisation to finance a demand-inducing stimulus will lead to higher demand, and companies will ramp up the production through existing unutilised capacities without increasing prices. A recent State Bank of India (SBI) report also emphasised that given the decline in the money multiplier, and the stagnant demand, debt monetisation is unlikely to have inflationary effects on the economy.[63]

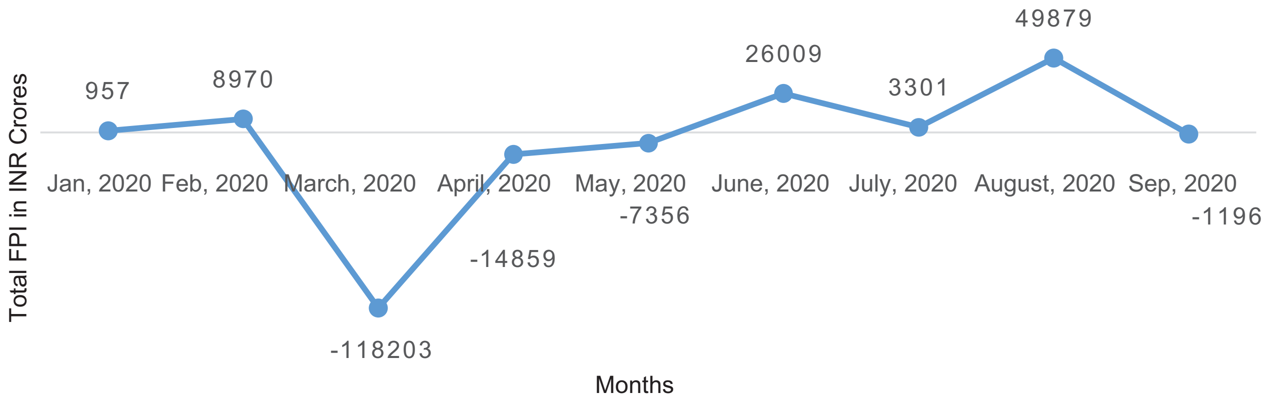
Increased Fiscal Deficit

The increased fiscal strain to fight the virus outbreak and the additional uncertainty created by the pandemic, could lead to flight of foreign and domestic capital, thereby collapsing the bond market.[64] However, foreign capital, for one, started exiting from India as soon as the pandemic emerged (See Figure 2). Indeed, this trend was noticeable in all emerging markets of the world, where foreign capital made money through cheap investments and was then cutting losses and booking profits by exiting the markets to go back to their safe havens (like the US).[65] Although, as lockdowns eased, India noticed a trend of positive FPI inflows in India, with a reversal taking place in June 2020 and a large net inflow in August 2020. While many considered this to be an effect of RBI's efforts towards containing the economic impact of the pandemic,[66] the reality differed.

The reason for the huge volatility in the foreign capital's response to India has been because this foreign capital has been moving in accordance with the actions of the central banks of the developed countries, rather than those of the emerging economies. As the US' central bank – The Federal Reserve, started printing money (close to $3 billion),[67] money began flowing again to the emerging world, including India. Since the foreign capital is reacting to the Fed's behaviour, it is likely that as normalcy returns, these FPI inflows could return to the safer havens.[68] This aligns with present trends as FPI inflow turned negative again in September 2020.[69]

Furthermore, even as concerns over shifting domestic investment are valid, there is a need to acknowledge that the shift of domestic capital might largely be because of the slowdown in the Indian

Figure 2: Total Foreign Portfolio Investment (INR crores)



Source: NSDL[70]

economy. In fact, India's domestic private capital might suffer more in the absence of debt monetisation and fiscal support.[71] In fact, a rapid build-up of the Indian economy can also attract investments when foreign capital again begins to invest in emerging markets.

Negative Effect on Sovereign Ratings

Debt monetisation could also lead to a downgrade in the country's sovereign ratings. This concern has been raised by Standard & Poor's (S&P) rating agency, which warned that if the RBI resorted to debt monetisation, it could undermine investor confidence and lead to a downgrade.[72] India's current rating status is just above junk grade and any negative affect on investor confidence could raise borrowing costs from abroad.

However, India's sovereign ratings can be downgraded even in the absence of monetisation. If India's economy remains stunted due to the lack of state fiscal intervention, foreign investors might anyway lose confidence in India's stability, leading to a downgrade. What would really retain investor's confidence in India is a pathway to rapid recovery – something which could be attained via monetisation and stimulus growth. Moreover, even if sovereign ratings are downgraded after monetisation, India's growth owing to the stimulus will dilute the effect from the downgrade. Indonesia has shown this:[73] the government's monetisation proposal did not trigger dramatic spikes in financing costs, thereby not affecting the country's ability to borrow money from the foreign market.

Decreased RBI Independence

Concerns over the independence of the central bank are valid.[74] However, the sort of debt monetisation suggested in this brief will monetise a large portion of the stimulus in the hands of the state governments, rather than banks. This would, to some extent, reduce the perception of the central bank overstepping its authority by taking fiscal actions and will help retain RBI's independence.[75] Furthermore, monetisation of state debt is suggested only as a one-time policy measure. Monetisation must not make monetary policy subservient to fiscal policy but aim to make the two temporary partners, in an effort to revive the economy.

To be sure, the RBI's independence could also come under strain as monetisation, which often leads to high inflation, might indicate India's shift from an inflation targeting regime.[76] However, the RBI's mandate includes targeting inflation through adjusting interest rates – something that it is still doing in the present circumstances as mentioned earlier; additionally, as already presented, inflationary effects due to monetisation are also unlikely. Pronab Sen, first chief statistician of India and former Principal Adviser at the Planning Commission, has further argued that India's present policy strategy could create higher excess money supply growth than debt monetisation's facilitation of greater government spending and greater private investment and consumption.[77] Similarly, the SBI report mentioned earlier also outlines concerns over Quantitative Easing being more inflationary than Debt Monetisation.[78]

To maintain the RBI's independence, the government must not force the central bank. The way forward should be taken within the larger legal framework of the RBI Act and in a consultative and transparent manner.

CONCLUSION

For India to survive the COVID-19 pandemic, both in terms of people's health and the health of the economy, the imperative is bigger and targeted government expenditure: to support small and medium enterprises, help vulnerable sections of the country, and test and treat more people.

The RBI's willingness to undertake unusual steps emerges from the need to steer the country away from the falling growth curve and rising infections curve. Despite resistance from some former governors, there is growing support[79] for the policy tool and even the RBI is considering debt monetisation in the latter part of the fiscal year 2020-21.[80]

It is essential, however, to monetise the states' debt instead of that of the centre, given the credibility and debt management issues associated with the Union government at present and the huge fiscal constraints the states are facing. Thus, monetising state debt to support a demand-inducing stimulus will work to fight the economic fallout of the pandemic from the grassroots.

The money generated via printing could work through a combination of fiscal expansion through states (with policies catering to cash and bank transfers, and employment guarantee schemes) and monetary expansion through the banks (steps for which have already been taken), after amending the FRBM Act (only in these times of difficulty). While debt monetisation comes with its own sets of issues, these can be addressed with proper policy management.

To stimulate growth, apart from external borrowings, large-scale asset monetisation is also being proposed. While this brief proposes the use of debt monetisation as an important policy tool, the use of one of these tools does not mean neglect of the other. The next stimulus does not have to come only out of monetised debt, and in fact, this brief suggests that only a portion of the total stimulus must be monetised. These policy measures must work in tandem to steer India out of the present crisis. The question that remains is whether the government should intervene radically soon, or wait—and let the pandemic take more lives and livelihoods.

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