Monetization: Neither Game Changer nor Catastrophe in Abnormal Times

There is a lot of concern in some quarters about central banks printing money to finance large budget deficits. And in other quarters there is concern that central banks are doing too little of it. Some worry that central banks are lending directly to the government. Others are assuaged when central banks buy government debt in the secondary market but not directly. Who is right? Since a number of students have asked me about this, and since the pronouncements of many public commentators and even officials seem confused, here is a primer.

There is no alchemy here, unlike the views of some – so called monetization is neither a game changer in stressed times nor a catastrophe. It helps a little at the margin, but does not solve the government’s fiscal problems nor does it lead to runaway inflation. If used in the wrong way, it could however be problematic. Since I have a number of Indian followers on LinkedIn, let me explain using the Reserve Bank of India’s current situation. RBI’s approximate balance sheet is below.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
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</thead>
<tbody>
<tr>
<td>Gold 2,30,000</td>
<td>Notes in Circulation: 24,13,000</td>
</tr>
<tr>
<td>Foreign exchange 33, 14,000</td>
<td>Reserve deposits: 12,00,000</td>
</tr>
<tr>
<td>Loans 3,40,000</td>
<td>Equity: 12,71,000</td>
</tr>
<tr>
<td>Investments 10,00,000</td>
<td></td>
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</tbody>
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The RBI’s assets consisted of about 49 lakh crores (1 lakh crore = 100000 crore = 1 LC) in total, of which the bulk were foreign exchange reserves (around 33 LC), investments in government bonds (around 10 LC), loans (to financial institutions) of about 3.4 LC, and gold amounting to 2.3 LC. These are financed by the notes in circulation (around 24 LC) and the reserve deposits commercial banks and the government have with the RBI (both notes and deposits are RBI liabilities). The rest is RBI equity, built up over the years largely through its ability to finance itself with notes that pay no interest, as well as its foreign exchange reserves that appreciate every time the rupee depreciates.

Suppose the government wants to spend a lot of money quickly. Let us say it wants to spend 1 lakh crore, which we will denote as 1 LC. It is best to distinguish two cases: A) Normal times and B) Abnormal times.

In normal times, the government will sell 1 LC of government bonds or bills in the market. Let us say commercial banks buy them. Now the commercial banks will transfer 1 LC from their deposit account at the RBI to the government. The government will then spend down that account. We will come to that in a moment, but the net effect is the banks own the government bonds directly, and have paid the government for it out of their reserve account. So the banks have 1 LC less than their desired amount of reserve deposits.

Let us say we are instead in abnormal times (like the present) and the government bond market is unprepared for 1 LC being issued suddenly. The government wants the RBI to buy the bonds directly. Let us say the RBI agrees (this has been prohibited by a past RBI/government accord). Now the RBI owns 1 LC of bonds, while the government has 1 LC in its deposit account. This is sometimes called money printing or monetization, though more appropriately, it should be called reserve creation. It looks like
the RBI is financing the government by expanding its balance sheet. But wait till we follow the trail to its end.

At the end of either transaction, the government has 1 LC more in its deposit account. Now what does the government do with the money in its account? In both cases it will spend it. Let it be deposited in government employee accounts as salary. They, in turn, will withdraw the money and spend it, and that money will be deposited by the local merchant in his bank account. Because the public had enough bank notes to begin with, most of the money spent by the government will be deposited back in bank accounts, which will then show up as increased bank reserves at the central bank. Put differently, unless the public wants more notes, and there is no reason to think it will, any spending by the government will show up as an equivalent amount of reserves held by the banks at the central bank. So the 1 LC in government deposits will show up after spending as 1 LC more of bank deposits at the RBI.

Hereafter, once again, there is a difference between the two cases. In normal times, the banks had spent 1 LC from their RBI deposits in buying government bonds. If the earlier level of deposit reserves was what they were happy holding, they are satisfied once again when the 1 LC comes back into their deposit account.

In abnormal times where the RBI bought the government debt directly, the banks now have 1 LC of excess reserves when the government spends its money. Reserves earn no interest if they sit in the bank’s deposit account at the RBI. If times were normal, banks would “use” up the reserves by lending more (say to businesses) and thus also expanding the deposits their customers hold with them. Since they need to hold RBI reserves against customer deposits, the expansion in their customer deposits would ensure their larger reserves at the RBI are no longer in excess. However, all this new lending would be expansionary and fuel inflation. This is why the RBI is reluctant to accommodate the government in normal times.

However, in abnormal times, banks are reluctant to lend to business. So they try and lend their excess reserves sitting in their RBI deposit account to other banks. No other bank wants it, so eventually these excess reserves are redeposited at an RBI special window called the reverse repo window at a low rate (currently 3.75%). Effectively, the RBI borrows from the banks through this window. On net, the RBI holds the government bonds, and the commercial banks finance it at the reverse repo rate.

**Implications**

1) Direct RBI financing is sometimes loosely termed money printing and thought to be free. This is misleading. As we have seen, the government finances itself from the RBI, and the RBI finances itself from the banks at the reverse repo rate of 3.75%.

2) Instead of the banks holding government bonds paying 6% or so, they hold claims against the RBI paying 3.75%. Of course, the claim they hold is shorter term and possibly more liquid. Most important, it is not subject to interest rate risk.

3) In abnormal times, the government gains by placing the paper quickly with the RBI, and the banks have no choice but to hold the excess reserves at a below-market rate. The only way out for an individual bank would be to make more loans or buy more government bonds. This it may
be reluctant to do because of the additional risks involved. Collectively, however, banks have no choice but to accept the reserves the RBI creates. This is why the financing is forced.

4) Such direct financing is not inflationary per se, so long as banks are reluctant to lend further to business or consumers. However, as normal times return, the central bank will have to pay a higher rate on excess reserves, or sell its government bond holdings and extinguish excess reserves, else it will risk excessive credit expansion and inflation. This process of extinguishing excess reserves is manageable (though see the caveat below).

5) The government does not get a free lunch. Not only is the RBI paying 3.75% for the money it lends to the government (which will reduce the annual dividend the RBI pays the government commensurately), the banks get 3.75% instead of the 6% they could get by buying the government bonds directly. Since the government owns 70 percent of the banking sector, its dividends from public sector banks also falls commensurately. Essentially, the small amount of government saving in its financing comes from the costs borne by the private banks. Their lower profitability will affect their capital and their lending over time.

6) Even though the way government spending is financed (either directly by banks or directly by the RBI) should not alter its inflationary consequences, the larger government spending will directly ignite demand. In abnormal times when demand is depressed and the environment is disinflationary, this should not be a central worry.

7) Similarly, the fact that the RBI will absorb government bonds seamlessly does not alter the fiscal math. If the fiscal deficit and the growth in government debt is deemed unsustainable, investors and rating agencies will take fright. This is where we need to put in place measures that ensure we will go back to fiscal health over the medium term – such as the debt target and the fiscal council suggested by the NK Singh Committee. Modern Monetary Theorists are wrong to think that central bank financing of the government can be ignored. The consolidated liabilities of the government and the central bank have to be seen as sustainable, else confidence in both money and government debt will collapse.

8) Some observers will have an important question. If the main difference in outcomes between direct RBI financing of the government and private financing of the government is the presence of substantial excess reserves, are we not already there? Is the RBI not already absorbing lakhs of crores through reverse repos? The answer is yes, we are.

Some obvious questions.

Why is the central bank hesitant to finance the government directly? Why does it insist on the fig leaf of the bonds being issued to the market and then the central bank buying through Open Market Operations (as the RBI has been doing in the last few years)?
As I have argued above, direct central bank financing in normal times can be inflationary (as can be excess OMOs). Moreover, direct financing of the government obscures market signals for a while when the government spends beyond its means. It is important the government get market feedback. The RBI/government accord allows the RBI to say no to the government, even if it rarely does so. It is best to retain the fig leaf.

**Is there no limit to RBI financing?**

Not so long as the banks are willing to passively reinvest excess reserves. However, the more the government issues to the RBI, the more debt the government will have to service, and the less creditworthy the debt. If the government’s debt falls in value, RBI’s balance sheet will get eroded. Once again, what is manageable in small quantities becomes problematic in excess.

**Why can’t the RBI pay the government a large dividend instead?**

If the RBI’s accountants agreed (they don’t), the RBI could increase the government’s deposit account at the RBI by 1 LC and say it was a dividend. While this would reduce the government’s notional fiscal deficit (it would now not issue bonds to the RBI) everything else would be the same. Ultimately, banks would have excess reserves, which would have to be taken in by the RBI at the reverse repo window. There are two related points:

1) The government’s true deficit would not be lower since it would have commensurately lower equity at the RBI (by the exact amount of the dividend). Essentially, it would be selling the family jewels (instead of borrowing) to pay for its spending. The government’s net debt, which is what rating agencies should worry about, would be the same.

2) The RBI would have fewer assets to sell to absorb the excess reserves when times normalized. This is not a problem if the amount to be sucked out is 1 LC, it does become a problem if it has to reabsorb 10 LC. Knowing this, market participants could become more worried about inflation.

**Should “monetization” be a constraint on government spending today?**

No, the government should be concerned about protecting the health of the economy and should spend what is needed. Obviously, it should try and cut back unneeded spending, and prioritize. It should also worry about getting the fiscal deficit and its debt back in shape over the medium term, and the more it spends now, the harder that will be. However, its inability to finance itself or fears of monetization should not be a constraint. Monetization will neither be a game-changer nor a catastrophe, if done in a measured way. In fact, India is already doing it! However, the caveat – it should be measured -- is key.