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Monetary policy for exceptional times

Monetisation of deficit is unlikely to spark inflation

The global financial crisis gave way to a new era in monetary policy where the conventional tools of policy rates were appended to unconventional policy initiatives like central bank asset purchase programmes, forward guidance, purchase of private assets, including corporate debt and commercial paper, among others. The experiment with quantitative easing led to decrease in duration risk and expectations that short-term policy rates would be lower for longer, which led to easing financial conditions and the measures being seen as a proxy for conventional monetary easing.

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Criticism of large scale quantitative easing range from impairment of market functions and stoking high inflation to distributional consequences among savers and borrowers. However, the experience over the past decade has shown that most of these fears were unwarranted, providing way for the construct and quantum of policy stimulus announced during the current pandemic.

Even in India, the central bank has been firing on all cylinders to ebb the tide of the crisis, moving away from the conventional monetary policy tools of repo rate cuts to more unconventional policy tools of long-term repo operations and targeted long-term repo operations (LTRO/TLTRO), Operation Twist, asymmetric cuts in the reverse repo rate, among others. This has led to higher liquidity in the system, anchoring of rates at the shorter end and a compression of term spreads and corporate spreads to an extent.

However, given the large borrowing programme announced by the Centre and state governments, albeit contingent on meeting pre-defined conditions, market expectation of other tools to absorb the large supply are rife. Some of the critical measures that are still expected by the market include open market operation purchase calendar, rise in held to maturity limits of banks, opening of a standing deposit facility window and deficit monetisation. Deficit monetisation for an emerging country like India might not often be the advocated policy tool but could prove to be the proverbial dark horse in our view.

A closer look at the current reserve money and money supply growth points out some interesting trends. While reserve money has increased due to the large monetary stimulus and an increase in precautionary demand (currency) for money, it has been lower than what would have been expected. Given the prevailing risk averseness in the banking sector along with weak economic growth, the higher liquidity in the system has not translated to credit creation. This in turn has led to banks parking a large amount of their balances with the Reserve Bank of India (RBI) using the liquidity adjustment facility reverse repo window, which has led to offsetting some part of the reserve money creation. At the same time, banks have seen a deluge of inflows into deposits, as is often the case in a low growth, high uncertainty milieu. Interplay of these forces has translated into lowering of the money multiplier, which we expect could reduce further going forward.

The velocity of money is often not talked about, but serves as a good indicator for inflationary impulse. In the conventional monetary relationship of money, output and prices — as defined by the quantity theory of money — it is often assumed that velocity of money is stable. So a given change in money supply would have an almost one-is-to-one impact on demand for money and thus inflation. However, the experience during the financial crisis has shown that velocity of money is subject to volatile fluctuations in the short-term, driven by the expectations of the economy and market trends. Moreover, velocity of money is not a cause but an effect, and a sharp fall in velocity of money, if not countered by an increase in money creation, could lead to recessionary impulses as was seen in the US during the Great Depression.

How does all this tie up with the debate on whether the RBI should monetise a part of the deficit? In simple terms, monetising fiscal deficit leads to the RBI directly purchasing government debt rather than the government borrowing from the market. In turn, the central bank prints more currency to finance this debt. How this really works is that when the government borrows from the RBI, the central bank's holding of government securities rises. When the government uses these funds, they get transferred into a commercial bank deposit account, and then in the commercial bank's account with the RBI, while also increasing net credit to the government, leading to an increase in reserve money. This increase in reserve money will lead to increase in money supply subject to demand for credit and deposit amongst other variables.

As explained earlier, given the falling money multiplier, this translation would be weak. Moreover, given the current economic slowdown, velocity of money could fall sharply. Thus, an increase in money supply (for a given low velocity of money), would not translate to a substantial rise in nominal gross domestic product. In other words, an increase in money supply, which only when rolled over frequently, would be inflationary, which we do not expect to happen currently. Moreover, monetisation of deficit, caveated by a clear usage of the funds and an exit strategy will uphold the credibility of the central bank. It would also give the public confidence of productive usage of the funds, rather than of a profligate fiscal policy, in turn tempering inflationary expectations and inflation.

To conclude, the turn of the 21st century saw a shift from high and volatile inflation in developed markets towards low inflation and anchored inflationary expectations, assisted by policy support, demographics, technological advancements. The global financial crisis saw the emergence of unconventional monetary policy tools, and increased debate on the oft-thought sacrosanct relationships between money growth and inflation. As an emerging market, India is subject to exogenous supply shocks impacting inflation. It has adaptive inflationary expectations and faces high deficit and debt ratios, and is subjected to scrutiny by foreign investors. However, the current pandemic calls for exceptional policy intervention and our research has shown that an appropriate quantum of intervention, defined with a clear use and exit strategy, should have minimal impact on macroeconomic fundamentals. And tools like monetisation could aid the current focus of the government and the RBI towards easing financial conditions and lowering the cost of capital.

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