In fiscal and economic policy parlance, monetization of fiscal deficit is broadly defined as the creation of money by the Central Bank to fund the fiscal deficit of the Government. The money so created is normally provided to the Government by the Central Bank against special securities created for this purpose, or through the purchase of general Government Debt, which would otherwise be sold in the open market.

Monetization of the fiscal deficit is frowned upon by economists primarily because of the inflationary impact of the money created to fund it. There is also the fear that if the deficit is funded at low or no cost, the political class may be tempted to ignore fiscal prudence and expose the country to large deficits ultimately resulting in uncontrollable inflation.

Until 1993, fiscal deficit in India was automatically monetized through the issue of special securities called Ad-Hoc Treasury Bills issued by the RBI on behalf of the Central Government to itself, that is, the RBI at a fixed rate of 4.60 per cent. After the crisis of 1991, this form of monetization came under severe criticism and following an understanding between the Central Government and the RBI, it was discontinued completely in 1997. All outstanding Ad-Hoc Treasury Bills were converted to Special Securities carrying an interest rate of 4.60%.

However, the RBI was still able to monetize the fiscal deficit by buying general Government Securities directly from the Central Government as and when required. This loophole was sought to be plugged by the Fiscal Responsibility and Budget Management (FRBM) Act in 2003, which envisaged a phasing out of this activity. Thereafter, the RBI could not create and hand over money directly to the Central Government. The focus of monetization then shifted to liquidity management

Since the RBI is also entrusted with the task of managing the Government's borrowing programme, it is responsible for ensuring that it is accomplished every year. After 2003, the RBI changed its strategy to ensuring that the domestic money market had enough liquidity to support government borrowings. RBI's intervention in the open market took on an urgency that did not exist before. Both, the domestic debt market, as well as the Foreign Exchange market were used towards this end. Since then, under the label of accumulating FX Reserves, the RBI intervened in the FX market to inject rupee liquidity into the system. This also served to keep the Rupee weak, which was thought to be a desirable outcome from the economic point of view.

However, reserve accumulation took on a life of its own and with exporters crying foul every time the Rupee appreciated, keeping the Rupee weak became a goal in itself. As a result, liquidity injection became just a desirable side effect and quantum of FX intervention no longer bore any relation to market liquidity requirements. There were times when the liquidity injected was far in excess of that required to support government borrowings and for these times, the RBI devised an instrument called Market Stabilization Bonds under a scheme called the Market Stabilization Scheme.

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These MSS Bonds were issued by the Government of India to suck up additional liquidity. The funds so raised were kept in a separate account and were not available to the Government in the normal course. These Bonds acted as a store of liquidity and were extremely useful when liquidity conditions were tight. The Government could buy them back as and when required to ensure the amiable conduct of its normal borrowings. This was most evident in the year 2009-2010, when close to 1/3rd of Government Borrowings for the year were financed through the liquidity created by buying these bonds from the market.

Whichever way one looks at this, it is clear that liquidity created through FX intervention is being utilized to fund the fiscal deficit. Monetization is still a reality, albeit through the Foreign Exchange backdoor. The cost of this monetization to the Government is now market linked, but that does not detract from the fact that money is still created by the RBI to ensure that the Government's borrowing needs are met. One can even say that the interest rate at which the Government borrows is also influenced by this monetization, since it's clear that without this liquidity, the Government would have to pay a significantly higher rate of interest.

Of the two reasons why monetization is frowned upon, only one has been tackled through all these years of supposed regulatory improvement. Since the Government now pays "market" rates for this monetization, the idea that its a free ticket does not exist. However, the inflationary impact of liquidity creation is still a reality. Monetization of the fiscal deficit, even through a backdoor, is still monetization.

The current year will prove the truth of this premise. In the absence of a significant stock of MSS Bonds with the market (most of them were bought last year), the only way in which liquidity will be maintained at an adequate level will be through FX intervention. Given the gap between the Government's borrowing requirement and estimated domestic liquidity, one can expect the RBI to buy at least USD 25 bln. through the year to fund it. Since the first few months of the year look to be comfortable from the liquidity perspective, one can expect this to start sometime in the second quarter of the fiscal year and intensify in the second half.

In case capital flows are in excess of this requirement, more foreign exchange will be bought, and MSS Bonds issued to sterilize the liquidity and create a stock for future needs. In case capital flows are lower than required, one would expect SEBI (in consultation with the RBI, of course) to increase the limit for FII investments in Government and Private sector Debt to the extent required.

And the RBI will monetize the Government's fiscal deficit for another year. And say that it stopped doing it in 2003.

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