A Misleading Debate

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For some time now there has been a debate in the country that is as esoteric as it is misleading, namely whether the Reserve Bank of India's reserves should be drawn down by the government to finance its expenditure.

On the one side, the argument is that if the government has to undertake extra expenditure, then, other things remaining unchanged, it would increase the fiscal deficit, while financing expenditure by running down the RBI's reserves entails no such increase in fiscal deficit; since an increase in fiscal deficit is supposed to be bad for the economy, it follows that financing larger expenditure by running down the RBI's reserves, which are in any case very high relative to its assets, higher than in many other countries, is socially desirable.

The argument advanced against this does not question this proposition at a theoretical level. It asserts instead that the government should not be undermining the autonomy of the RBI, using it as a tool for appeasing the electorate through larger spending in an election year.

In fact however the argument for running down the RBI's reserves is theoretically erroneous for two reasons: one, there is no difference whatsoever in terms of macro-economic impact between increasing the fiscal deficit and running down the RBI's reserves; a proper definition of the fiscal deficit should actually include the running down of the RBI's reserves as well. Two, an increase in government expenditure financed by a larger fiscal deficit is not always a bad thing; indeed in many situations, like India today, a deficit-financed increase in expenditure is better than no increase in expenditure, though of course it is worse than a tax-financed increase in government expenditure.

Let us see what increasing expenditure by running down RBI reserves implies. Since the RBI's *liabilities*, which include reserves, must equal its assets (which include the *forms* in which reserves are held), running down reserves requires a reduction in assets. One way of effecting it is to reduce additions to assets by increasing the dividends that the RBI gives to its owner, the Government of India.

Reserves therefore can be run down by being distributed as dividends to the government. If reserves are reduced by Rs.100 by increasing the RBI's dividends to the government, which constitute the government's income, and the government in turn spends this sum, then the fiscal deficit (which measures the excess of government's expenditure over its income) remains unchanged; so, expenditure goes up by Rs.100 but the fiscal deficit remains unchanged.

This reasoning however is wrong. It is true that if we take the government *in isolation* its fiscal deficit does not go up when increased dividend income balances increased expenditure; but the appropriate deficit to look at is that of the government sector *as a whole*, including both the government proper and government-owned institutions like the RBI. If we do so then we find that the deficit of the government sector as a whole has gone up: the government sector's expenditure has increased by Rs.100, but its income has not increased, since the dividends given by the RBI to the government proper, represent only an internal transfer within the government sector, but not an increase in the income of the sector as a whole. Hence an increase in expenditure when financed by a drawing down of RBI reserves causes as much of an increase in the government sector's deficit as when it is financed by an increase in the fiscal deficit narrowly defined. Its macroeconomic impact therefore is no different from that of an increase in the fiscal deficit narrowly defined.

But what is this impact likely to be? The idea that an increase in the fiscal deficit always causes inflation is obviously wrong. Inflation, leaving aside the "cost-push" variety, which is quite independent of the fiscal deficit anyway, arises when an excess demand arises at the prevailing prices for the goods and services in the economy that cannot be eliminated through increases in supply. Since supply cannot be increased, such excess demand can be eliminated only through a rise in prices which reduces the demand of those whose money incomes are not indexed to prices and take time to adjust to the price-rise. The overwhelming majority of the workers, including above all agricultural labourers, belong to this category of fixed-money-income earners. In an economy where supply can increase in response to an increase in demand, that is, in a demand-constrained economy, an increased fiscal deficit need not cause inflation.

The Indian economy of late has been a demand-constrained one, with foodgrain stocks well above what are considered "normal" and large-scale foodgrain exports the order of the day, and with industry characterized by unutilized capacity. True, an increase in demand could spill over into a larger current account deficit on the balance of payments, rather than an increase in domestic supply; but this requires restrictions on imports, which even Trump has introduced, rather than withholding an increase in demand. The view that a larger fiscal deficit is bad for the economy is therefore neither valid in general nor for the Indian economy at present, though of course if the increased demand effected through larger public spending financed by a fiscal deficit is achieved instead through larger tax-financed public spending, then so much the better.

This does not mean that we should necessarily endorse all kinds of public spending; but the excuse often advanced, that welfare and social-sector expenditure by the government is constrained by a lack of resources, cannot stand scrutiny, a point worth emphasizing at a time when even the Mahatma Gandhi Rural Employment Guarantee Scheme is being run to the ground.

It follows therefore that the protagonists on both sides of the debate, those who want the government to use the RBI's reserves for larger spending and those opposed to it, share theoretical premises which are erroneous. The government does not have to use the RBI's reserves; it can simply augment the fiscal deficit whose effects would be no different from using these reserves. And these effects need not be deleterious either.

As for the "autonomy" of the Reserve Bank, it is as dangerous to leave the RBI to be managed in accordance with the caprices of a bunch of global financiers (which is what "autonomy" in effect implies), in total disregard of the people's interest, as it is to leave it to a government pandering to a set of "crony capitalists". The RBI must be made accountable to the people at large, for which appropriate institutional mechanisms must be set up, involving for instance parliamentary oversight, among other things.

But is the government's desire to use the RBI's reserves, rather than a fiscal deficit, for increasing its expenditure, a matter merely of theoretical misunderstanding? Not really, because globalized finance may not notice the use of RBI reserves, and be as upset with it, as it would be with a fiscal deficit. Using RBI reserves, though effectively no different from a fiscal deficit, constitutes a form of “window dressing”. But it is essential not only that we extricate ourselves from thralldom to the caprices of globalized finance, but also that our public discourse is informed by economic theory that is free of obfuscations.

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