What is a deficit in the Financial World?

In financial terms, a deficit occurs when expenses exceed revenues, imports exceed exports, or liabilities exceed assets.

A deficit is synonymous with a shortfall or loss, and is the opposite of a surplus. It occurs when a government, company, or person spends more than what is received in a given period, usually a year. Running a deficit will erode any current surplus or add to any existing debt load, whether the situation is personal, corporate, or governmental.

Now the question arises “How is a deficit sustained and covered when a whole country or a company faces one in their books?”

This is where the concept of Deficit Financing comes into effect.

So, what exactly is this “Deficit Financing”?

Simply put, deficit financing means generating funds to finance a deficit.. The gap is covered by borrowing from the public by the sale of bonds or by printing new money. Higher economic growth is a priority for emerging countries like India, and this necessitates financial resources. Since the private sector is hesitant to make large investments, the government is responsible for obtaining financial resources. Often, both the tax and non-tax revenues fail to mobilize enough resources, making a deficit inevitable.

But, if a country can simply finance its deficits through such methods as and when it needs to, why is their unabated use considered to be a problem? Well, it is because there are numerous pitfalls of Deficit Financing. Many people believe that deficits are unsustainable over the long term. Printing new currency notes increases the flow of money in the economy. This leads to an increase in inflationary pressures which cause a rise in the prices of goods and services in the country. Deficit financing is inherently inflationary since it raises aggregate expenditure and hence, increases aggregate demand.

Several Economists argue that they also provide jobs to foreign countries instead of creating them at home, hurting the domestic economy and its citizens. For instance, when a country has a Trade Deficit i.e. when its imports surpass its exports - we witness a net outflow of money from the country. Many also argue that governments should not run fiscal deficits on a regular basis because the expense of debt payment diverts resources that could be used for more productive purposes, such as education, housing, or public infrastructure.

On the other hand, the famous British economist John Maynard Keynes maintained that fiscal deficits allow governments to purchase goods and services that can help stimulate the economy— and therefore, are a useful tool for bringing nations out of recessions. In fact, there are several situations where Deficit Financing plays a key role.

For example:

- To finance defense expenditures during war - for instance, debt financing was used to meet war expenses during the Second World War to finance war-cost during the Second World War, massive deficit financing was made.

- To get the economy out of the doldrums so that earnings, employment, investment, and other factors can all improve.

- To mobilize idle resources and redirect resources from unproductive to productive sectors, in order to increase national income thereby resulting in economic growth.

- To increase capital formation by mobilizing forced savings made through deficit financing.

- To mobilize resources in order to fund large-scale planned expenditures. For example, the Government of India has been using this technique of financing to obtain additional resources since the debut of the Five-Year Plans. It plays a crucial role in any plan for our long-term economic development.

The crux remains, that if traditional sources of funding are insufficient to cover public spending, a government may turn to deficit financing.

Let us summarize the Risks and Benefits of Deficit Financing:

Deficits are not always unintentional or the sign of a government or business that's in financial trouble.
Businesses may purposefully run budget deficits in order to maximize future profits potential, such as retaining personnel during slow months to maintain sufficient workforce during busier periods. In addition, some governments run deficits in order to fund significant public projects or continue citizen programmes.
During a recession, a government may purposefully run a deficit by reducing revenue sources such as taxes while maintaining or even increasing expenditures, for example, on infrastructure—to generate jobs and income. According to theory, these actions will increase people's purchasing power, and hence stimulate the economy.

But deficits also carry risks. For governments, the negative effects of running a deficit can include lower economic growth rates or devaluation of the domestic currency. In the corporate world, running a deficit for too long a period can reduce the company's share value or even put it out of business. Also, it affects investments adversely. Employees seek higher wages in order to meet their cost of living when the economy is experiencing inflation..This, in turn, increases the cost of production which demotivates the investors.

Now, the talk on investments brings us to another pertinent aspect which is Interest rates and their effects on an Economy.

What is the first thing that comes to your mind when you hear the term ‘interest rates’?

Most probably, it is the interest on loans which we take.You are more or less correct, but there is a lot more to the story.
Let us start from the basics.

Interest rates can be viewed from two perspectives. One is from a borrower's point of view and the other, from a savers point of view.

From a borrower's standpoint, the interest rate determines the amount of money which will have to be paid back in addition to the principal amount.

From a saver’s perspective, the interest rate determines the return on investment.

While these rates may appear to be insignificant to the vast majority, their economic importance cannot possibly be understated. They impact our economy in numerous ways.

Interest rates are very important economic ‘tools’ since they influence all business activities.

The Reserve bank of India frames the Monetary Policy to stabilize economic activity and promote prosperity of the economy.

One of the most important monetary policy tools is the repo rate that it sets.

Repo Rate is the rate at which the Reserve Bank of India lends money to commercial banks or financial institutions in India against Government securities.

The current repo rate is at 4%

When the RBI sets the repo rate, commercial banks borrow money from them and lend out the money at a comparatively higher rate. This is how they work and earn profit.This process helps money to keep moving in an economy. Thus,the repo rate determines the rates of all loans in the country.

It is therefore evident that a small increase or decrease in the repo rate will change the course of the economy.

When the RBI reduces the repo rate, banks can borrow money from it at a lower rate and hence lend money to institutions and consumers at a lower rate too. This reduces the cost of borrowing for companies and hence they can employ more people. With the increase in employment rate, consumers have more money to spend. It is a win-win situation. This mechanism is employed when the economy is facing a crisis or becoming stagnant.

On the other hand, when the RBI increases the repo rate, banks borrow money from it higher rates and lend money to the public at higher rates. This makes loans very expensive. Consequently, people reduce taking loans. It also becomes costly for institutions to take on new ventures and hire more people. Their profitability decreases and employment rates go down. This seems to be a very bad move and might make you wonder why an economy would do such a thing in the first place. Well, every economy has a sustainable level of activity which it can operate at, and when it accelerates beyond that level, it can overheat due to the lack of spare capacity.

When interest rates decrease, there is a high level of economic activity due to more employment.People tend to borrow more due to the lower cost of borrowing and everyone seems to have money to buy. This leads to increased consumer demand for products. Consequently, prices for commodities increase. This means that though people have more money to buy, their wealth or purchasing power has decreased. This increase in the price level is called inflation. Every economy tries to achieve a fixed inflation rate. But due to these decreased interest rates, inflation is left unchecked and it may increase drastically.

Now, what can we do to prevent this?

When the economy grows at a much faster rate, the government has to reduce the speed by increasing interest rates.

This leads to people borrowing less, which in turn reduces demand and thus, slows inflation down. As the interest rates increase, the profitability of companies decreases and they do not hire more employees. This might have a short term negative effect but is a beneficial and much needed move in the long run.

There may be volatility in the short run but in the long run, things will adjust.

The recent decision of the US Federal bank to increase interest rates from March is a good example.

During the start of the Covid-19 pandemic, people lost their jobs, businesses were hit, demand dropped and the economy came to a halt. In these tough times, interest rates were reduced globally and liquidity was infused into the system. This was done to boost the economy and create job opportunities. The rates in the US were down to close to 0%.

As interest rates went down, it became cheaper to borrow money. People and companies were readily taking loans and as a result, they were spending more. This fueled the economy. But now, as things are going back to normal, with inflation in the USA reaching 7%, the US Federal Bank has decided that its time to gradually increase interest rates again.

So, what approach is better for the Economy of India?

High Deficit Financing v/s High Interest Rates:

An economy is controlled by both its Government and its Central Bank. Both have to formulate policies that are complementary to each other's.
There has been large-scale criticism in India, with regard to the coordination of policies formulated by the Government of India and the Reserve Bank of India. The lack of coordination issue has remained a hot discussion topic.

A country's economy is steered by two types of economic measures by the policy makers – Fiscal and Monetary. While Fiscal policy is framed and implemented by the government with regulation of its spending and collection of revenue, the Monetary policy is controlled by the Central Bank of the country. In India, this is The Reserve Bank of India - or, the RBI.

Deficit Financing by Government is a measure used to increase money in the Economy

When demand in an economy becomes low, the government steps in and increases its spending to provide a stimulus. It also increases the disposable income of people by lowering the tax rates. In this way, it manipulates the level of aggregate demand in the economy.

This is done in order to achieve the economic objective of price stability, economic growth and full employment.
Fiscal deficits and public debts at unsustainable levels can lead to fiscal dominance, resulting in high and volatile inflation and increased risk of unmanageable government debt. If the Government during inflationary trends decides to bring out more budgetary deficits, resorts to the fortune of subsidies, more public spending and more public debt, and resorts to hefty deficit financing, it increases money supply in the economy and assists in increasing the rate of inflation instead of checking it.

Now, Interest Rates and Reserve Ratio are controlled by the RBI.

- An unfavourable exchange rate dynamic – linked to weak fiscal and monetary policy credibility is the key factor in the destabilised capital outflows.
- The Reserve Bank of India, the Monetary Authority, in order to curtail money supply resorts to quantitative control measures like higher bank rate policy.
- But, Deficit financing nullifies the contractionary effect of monetary policy with the implementation of expansionary fiscal policy.

- In India, Fiscal policy is more oriented to achieve political gains than economic ones. In almost every budget, the fiscal deficit target is pegged at 5 to 5.5 percent of the GDP, but the government finds it difficult to stick to the Budget estimates mainly because both the policies are not complementary to each other.

In conclusion, we find that a developing nation, such as India, needs primary surplus.

The Monetary and Fiscal policies are required to follow each other in the right perspective in order for the Indian economy to reach greater heights. The RBI Deputy. Governor H.R. Khan was of the view "As we have articulated time and again, it (monetary policy) has to be in tandem with the fiscal policy. It has to be a joint venture. It is not a solo play,". Focusing on the primary deficit is very important. It is the indicator of understanding where we stand.
Under normal circumstances, it is always better for a country to run primary surpluses.

Therefore, the Fiscal and Monetary policy have to be framed and implemented coherently to achieve a set of objectives which are oriented towards the growth and stability of the economy. However, in India for the past two decades, mismatch between the fiscal and monetary policies have remained a major concern in the emerging market economy.

When there is deficit financing, the high bank deposit and advance rates attract customers to keep their deposits in banks and due to high rates, fewer borrowers turn up for loans. Thus, the Monetary policy defeats the impact which the fiscal policy wanted to create.

However, the Government has now taken some bold steps of doing away with subsidies and FDI in retail. It appears that the country is coming out of the current account deficit and the balance of payments is moving into surplus territory. Appreciation in the rupee is expected. Money markets are also expected to react positively to it with the greater confidence of foreign investors. A well designed monetary policy is required to support these growth prospects.

Hence, we need both of them to go hand-in-hand, complementing each other to further boost our Economy and raise our country to a higher financial altitude like the developed nations, such as the USA, Europe and so on.

This article has been written by:

Mehul Agarwalla (B.Com (Hons.) Morning) first-year student at St. Xavier's College, Kolkata, and a part of the Core Finance Team in the Xavier's Finance Community.

Nirbhik Das (B.Com (Hons.) Morning) first-year student at St. Xavier's College, Kolkata, and a part of the Core Finance Team in the Xavier's Finance Community.