

Demystifying G-SAP with Modern Money Theory

By announcing a massive bond purchase programme, the G-SAP, the RBI assures infusion of enough liquidity (a swap of bonds for reserves) into the system before it will be drained out when it auctions new government bonds (a swap of reserves for bonds), thereby maintaining money markets rates within the target range

[SASHI SIVRAMKRISHNA](#)

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The last few days have seen a flurry of discussions over the possible disruption in money markets due to the necessity of large borrowings by the Indian government to fund this year's fiscal deficit. It began with concern over bond vigilantes but has now moved on to the Government Securities Acquisition Plan or G-SAP.

Engagement with the technicalities of operations by the Reserve Bank of India (RBI) shifts focus away from the macroeconomic implications of why such operations are necessary in the first place and what are their larger objectives. An MMT (Modern Money Theory) perspective of fiscal-monetary operations helps in clearing the air over these broader questions.

At the most fundamental level it is important to be aware of what a state (combining the government and the central bank) issuing its own sovereign currency actually borrows and what it repays; the answer to both being its own financial liabilities, which it is the monopoly issuer of. Currency, government bonds, and reserves or reserve accounts held by commercial banks at the central bank are all financial liabilities of the state. Some are interest-bearing while others may not be. When a central bank “buys”/“sells” bonds from/to banks, it essentially *swaps* its own financial liabilities, i.e. bonds for reserves or vice-versa.

The question then emerges as to why does the state need to “borrow” its own financial liabilities in the market for its spending? In fact, for a very long time it did not. Governments would simply issue bonds to their central banks in exchange for a credit of the corresponding amount in their account and then spend. This is called debt monetization. The spending would then lead to net credits in the reserve accounts of the commercial banks (an increase in liquidity) as well as net credits in the deposit accounts (held at commercial banks) of non-bank private sector (NBPS) recipients of the spending.

If this amount with the NBPS was likely to cause excess aggregate demand in the economy it could be drained out through increase in taxes and/or savings schemes like provident funds, which are essentially issue of financial liabilities by the government. At the same time, the excess reserves held by commercial banks at the central bank were drained out through swap of reserves for bonds so that money market rates were within the target range to achieve the inflation target. If such money markets were undeveloped and/or inflation targeting policies had not been adopted, the state ensured that excess reserves did not incentivize cheap lending by banks using administered interest rates, credit rationing and/or even nationalizing banks to enforce control over credit creation and consequent inflation.

All this changed in the era of the Washington Consensus. State spending was sought to be curbed and this was done by pressurizing governments to impose constraints on themselves – a 3% of GDP fiscal deficit target and making it mandatory that they first tax or “borrow” and then spend, i.e. they must have positive balances in their accounts before spending. In India, this revised policy framework was legislated by the passing of the Fiscal Responsibility and Budget Management (FRBM) Act 2003. The package of fiscal constraints was followed by the subsequent introduction of two crucial policies on the monetary front: inflation targeting and central bank independence. The government and the central bank would jointly decide on an acceptable inflation target, which had then to be achieved by the central bank. To do so, the central was given an instrument – setting the interest rate (the repo rate) – which was solely at its discretion although this has been partially watered down by appointing a monetary policy committee (MPC). Inflationary pressures arising from profligate government spending could then be checked by hiking interest rates and curbing private sector demand.

Governments and central banks have from then on functioned within this neoliberal fiscal-monetary architecture. Government spending and tax collections create liquidity imbalances that impact money market rates and the central bank’s ability to achieve the inflation target. As described by the MMT economist, [Scott Fullwiler](#), these liquidity imbalances are corrected through a well-timed sequence of repo and open market operations (OMOs) involving a network of primary dealers and major banks.

In India, the unusually large fiscal deficit this year and the resolve not to resort to debt monetization, implies that the RBI must deal with the government’s huge borrowing programme. This initially led to a concern whether bond vigilantes could demand higher yields in order to supply necessary funds for the government’s borrowing programme. However, as MMT has always argued, the power of bond vigilantes is overestimated given that the central bank can always control the interest rates. And this is precisely what happened last week. In a single stroke, by announcing a massive bond purchase program, the G-SAP, the RBI assures infusion of enough liquidity (a swap of bonds for reserves) into the system before it will be drained out when it auctions new government bonds (a swap of reserves for bonds) thereby maintaining money markets rates within the target range. While the G-SAP has calmed nerves on adequate availability of liquidity for its forthcoming auctions, the RBI has further clarified that it will continue to use existing instruments including repo, reverse repo and operation twist to manage shorter term mismatches in demand for and supply of liquidity as well as the yield curve.

When we look at the whole sequence of fiscal-monetary operations from an MMT lens, it becomes clear that even within the present architecture, the state is really not “borrowing” only (its own) existing financial liabilities – if this were indeed true, there would be no net change in public debt or net accumulated financial liabilities over time. Bond purchases/sales and repos/reverse repos are therefore monetary policy instruments to manage liquidity, which constantly oscillates with government spending and tax collections as well as the need of banks in response to credit expansion and contraction. In particular, bond “sales” are not a fiscal policy instrument to fund government expenditure and the Indian government’s ability to spend is not constrained by private sector savings or lending.

SASHI SIVRAMKRISHNA is an economist, economic and environmental historian, and documentary filmmaker. Twitter: @Sashi31363. Views are personal.