The war against COVID is on. This is how we can finance it

How the British financed World War 1 could provide clues on how to fund the war against the pandemic in India

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Following the two-week COVID-19 lockdown announcement, people were seen leaving for their hometowns at a bus terminal in West Bengal. (Image: ANI)

As the human tragedy unleashed by the second wave of the COVID pandemic continues to unfold across India, its economic cost on individuals, families and businesses will only add to the suffering. A decline in GDP growth, increasing unemployment, resumption of reverse migration, closure of MSMEs and disruption of service sector businesses is now more than an imminent possibility, even if there are differences in opinion over the degree of impact as compared to the effects of the first wave.

The uncertainty over the economy is accentuated by uncoordinated regional lockdowns, the spread of the virus into rural India, the under-reporting of cases and deaths, uncertainty about how long the wave will continue, and finally, the alarm sounded on the inescapability of a third wave within a few months.

While the Reserve Bank of India (RBI) has announced a few monetary policy initiatives to address the economic impact of the second wave, there are no major policy measures announced by the Ministry of Finance as yet. In fact, its recent position on the matter was that the second wave will have a 'muted impact' on the economy.

This seems untenable given the ferocity of the second wave and consequent inevitability of the fiscal deficit breaching the targeted 6.8% of GDP. If this were to happen, economists and experts will issue warnings over the consequences of deficit and debt that will directly or indirectly begin to exert subtle pressure on the government to resort to austerity measures. Fears over the fiscal deficit also get translated into simplistic remarks that are common in discussions; 'the government doesn't have the money', 'where will the government get money from?' or 'the government cannot afford to spend'.

Modern Money Theory (MMT) not only allays fears over such an over-simplified understanding of macroeconomics but could also guide a more discerning financial response to the crisis. And there is perhaps no better way to appreciate this than to look at some lessons from war financing through an MMT lens. After all, aren't we already waging nothing less than a war against a very deadly enemy?

On August 4, 1914, Great Britain declared war on Germany. On the very next day, the Currency and Bank Notes Act, 1914 was issued by which the gold standard was suspended with immediate effect and in lieu of gold sovereigns and half sovereigns, the British government was allowed to print notes or more precisely, issue fiat currency as legal tender. The purpose of the Act was to allow the government to provision itself by purchasing real resources from its private sector – manpower, food and medical supplies, arms and ammunitions, etc. – to fight the war. However, given possible delays in the printing of notes, the **Act even allowed postal orders** to 'temporarily be current and legal tender in the United Kingdom in the same manner and to the same extent and as fully as current coins.'

This is the essence of modern money: an economically sovereign nation issuing its own fiat currency which is also legal tender, faces no financial constraint. India is a case-in-point. To keep the process simple, the Government of India (GoI) could borrow directly from the RBI – what is referred to as monetizing the debt – to provision itself with financial resources (rupees) that are required to purchase real goods and services from the private sector to control the pandemic including medicines, oxygen, vaccines, healthcare personnel, etc. However, the power to create money *ex nihilo* is a prerogative of the central government only, and not state governments and/or local authorities like municipalities.

This, however, is part of the story. Although the government does not face a financial constraint, MMT emphasizes the unequivocal importance of addressing real resource constraints. For instance, do we have an adequate supply of oxygen and vaccines available internally? If not, the government could borrow (from the RBI) and utilize a small fraction of the existing US$ 580 billion foreign exchange reserves to purchase what is required (and is available) from abroad. Interestingly, Iran did this late last year to import vaccines albeit clandestinely on account of US sanctions.

Along with medical supplies and infrastructure to be procured on a war footing, the government will also have to deal with contraction in aggregate demand and closure of businesses including those in the informal sector. This aspect can only be addressed with large-scale income distribution, MNREGA spending and direct transfers to MSMEs and small businesses. Once again, such expenditure if it were to be provided by the central government – as it would have to be, given the likely shortfall in state government revenues – the fiscal deficit would further widen.

What are the implications of the government borrowing from the RBI? The bonds issued by the GoI appear as a financial liability in its balance sheet and simultaneously as a financial asset in the RBI's balance sheet. However, when the GoI spends the money it will increase reserves held by commercial banks at the RBI as well as deposit accounts of the non-banking private sector (NBPS) held at commercial banks. The final effect will be net financial asset [liability] accumulation by the NBPS [GoI]. It is then possible that excessive purchasing power with the NBPS could exert inflationary pressures in the economy – a consequence that MMT has repeatedly cautioned about. Here again, there is a lesson to learn from war financing. To drain excessive purchasing power the British government issued 5% national war bonds in 1917 with advertisements and appeals:

> 'If you cannot fight, you can help your country by investing all you can in 5 per cent Exchequer Bonds ... Unlike the soldier, the investor runs no risk.'
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> 'It is the people of Great Britain who must provide the cash with which to finance the war, and there is little reason to doubt that they can do it if only they will. A large part of the nation, instead of being impoverished by the war, has been enriched.'

These bonds were sold as if the government was raising money to fund the war. However, as MMT argues, bond sales are actually a way of deferring spending by the NBPS on goods and services and quell inflation. This is evident once we realize that bonds (financial liability of the government) were essentially swapped for currency (also a financial liability of the government) that had already been spent. In the present context, such bond sales by the RBI to the NBPS would not only drain excessive purchasing power with the NBPS but also drain excess reserves or liquidity that commercial banks have with the RBI (when the GoI spent the money) and thereby ensure stability in money market interest rates.

The clear message from MMT is, therefore, rather han fear financial constraints, there is an immediate need for the government to focus on the availability and creation of real resources to fight the pandemic and at the same time, ensure that aggregate supply does not collapse and is able to quickly respond to a revival of aggregate demand.

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