

PAKISTAN: WHY DEFICIT FINANCING HAS NOT WORKED AND ALTERNATIVE STRATEGIES

By Afreen Baig

(Afreen Baig is an economic analyst. Here she presents an analysis on the current fiscal policies and economic guidelines being pursued in Pakistan, with an emphasis on deficit financing, and why these continue to fail. Some alternatives are suggested. She can be reached at afreenbaig@gmail.com)

The World financial crisis of 2008 – 2010, exposed the weaknesses in the several of the first world economies, which were earlier considered to be the paradigm of economic success. Failure of the banking system, collapse of sub-prime mortgage business, ascending debt-to-GDP ratio, unpredictable unemployment and bankruptcies declared by several established businesses, raised serious doubts regarding the foundations of those economies.

Pakistan and most of the Middle Eastern economies have remained safe from the domino effect of the world financial crises, both for entirely separate reasons. The problems confronting Pakistan's economy are due to economic mismanagement, living in quandary regarding policies, misplacement of priorities and corruption - not worldwide recession.

While the first world countries continue to have the resources and finances to deficit finance their economies out of recession, to push start the cycle and to increase the aggregate demand – third world and smaller economies like Pakistan have few viable options to exercise, these options being more functional and realistic.

Over the years, the first world or developed countries have converted their economies into well-documented ones, bringing an end to leakages and corruption. This documentation along with the checks & balances of financial institutions, helps them to measure and record, the consequences of various modes of quantitative easing or deficit financing. Although the outcome may not be as perfect, however, it allows the economy some breathing space and the government to implement long term structural reforms.

Foreign reserves are one of the best resources, in times of financial crunch, to shore up liquidity in banks and markets, to protect investments and support government spending. Concurrently, a reserve is an important indicator signifying the ability of any nation to repay foreign debt. Consumption of reserves is also a form of deficit financing. If a country has enough foreign reserves, it doesn't need to borrow from other countries and monetary institutions to finance its national budget or overall economy, owing to its inability to generate revenue. Those

developed or sensible countries that skipped facing the harsh effects of the recession were mainly those that held foreign reserves in abundance in ratio to their GDP, fiscal deficit and external debt.

Unfortunately, Pakistan saw a loss in its foreign reserves that declined to \$6 billion by November 2008, from \$16.5 billion in November 2007, and a trade deficit that exceeded \$18 billion. This imbalance led to devaluation of Pakistani currency, which in return also multiplied our foreign debt and debt servicing. Since, revenue generation was not sufficient enough to compensate the imbalance produced by this negative chain reaction, therefore, various modes of deficit financing were applied as short-term strategy.

Deficit Financing

Deficit Financing is a strategy where, usually the government deliberately spends more money than it accumulates through revenue collection. While deficit financing may be applied for various reasons, one of the main purposes is to stimulate the economy in order to bring an end to a phase of recession. However, in third world or emerging economies, like Pakistan, deficit financing may also become a requirement due to inefficient governance, extravagant and unplanned spending, corruption, tax evasion or insufficient tax collection.

Some of the popular formats of deficit financing are; seignorage (deficit monetization), floating sovereign bonds or treasury bills, sale of fixed assets, utilization of foreign reserves, borrowing from citizens abroad, borrowing from international financial institutions or other countries.

If applied properly for a short term period, deficit financing facilitates to launch that positive chain reaction, which in return enhances the economic condition rather just creating public debts. However, if the objectives are not accurately chalked out, monitored and controlled – the economy may end up witnessing excessive and unwarranted burden of public debt and increased debt servicing – placing the governments in debt to foreign creditors, raising the chances to default, and become the cause for a double-dip recession.

The Developed World Case

How successful have the western economies been in deficit financing their economies towards long term stabilization?

USA - the world's largest economy, with a GDP estimated at \$14.3 billion, saw unemployment that was at decade's high rate of 9.5%, during this recent recession; which is being considered as one of the worst downturn since the Great Depression of the 1930s, with businesses shedding approximately 8.5 million jobs.

The US government responded with unprecedented bank bailouts worth \$700 billion and a further \$787 billion fiscal stimulus package. According to data compiled by Bloomberg, the US has spent or guaranteed bailouts worth \$11.6 trillion, only little less than the worth of their total GDP. With Interest rates lingering around zero percent and around \$300 billion already given in tax cuts – this had to be the best possible approach.

The wars after 911, in Afghanistan and Iraq, forced the national debt to swell from \$5 trillion to \$13.5 trillion today. Since 1770s, the US national debt has been soaring higher - fueled by wars, economic recessions and accumulated budget deficits. The USA had to deficit finance their economy out on every occasion, consequentially raising the debt to about 100% of their GDP.

Today, USA's GDP is \$14.3 billion and a public debt of \$13.92 trillion. Additionally, the USA has a trade deficit of \$0.501 trillion and budget deficit of \$1.409 trillion. Their reserves are a negligible \$129 billion in comparison to their national deficits, inadequate to support the imbalances created in the overall economy.

For USA - Deficit financing has not helped produce that positive chain reaction, to generate sufficient revenues, in order to overcome the annual deficits or lessen their public debt. The economy shall continue to heat up, unless the guiding principle adopted is that of long term revenue generation and balance in the macro-economic indicators with respect to their GDP. However, since Dollar is the reserve money in the world, there is hardly any chance of US sovereign default.

Similarly, the Economy of UK has not been that ideal, and years of deficit financing, including the current tranche of bailouts and quantitative easing, worth around £1.122 trillion and interest rates cut as low as 0.5%, for the past two years months, from 4.5% in 2008 - has not provided an alternative model for long lasting economic growth and sustainability.

Today, UK - the world's 5th largest economy, has a GDP of around \$2.15 trillion and a public debt of \$9.12 trillion. Additionally, they have a trade deficit of \$123 billion and a budget deficit of \$312 billion, complimented by their pitiable foreign reserves of \$53 billion. UK's external debt as percentage of their GDP has rocketed to 424% and the outlook to 2011 is as perturbing, as throughout the recession period of 2007-2010, even after the various modes of deficit financing. However, again the value of pound as a reserve currency makes it easier for UK.

Despite whatever improvements the economists anticipate, most of the European economies keep heating up, are susceptible to the smallest indication of financial downturn and the recovery starts flagging in any case, in spite of all attempts at deficit easing. The sole reason for this heating up is that they have become amongst the world's highest indebted nations, due to years of deficit financing, with their revenue generation not ample to support their growth on their own.

Most of these European economies have become disaster-prone, unless they make resolute attempts to lower their debt to GDP ratio, and further make every effort to bring about equilibrium in their major economic indicators, even if they are unable to achieve budget surplus.

The Case of China

China – on the other hand, has been in a fairly better position, primarily due to its balanced macro-economic indicators and prudent policies. Pragmatic and calculated economic reforms of late 1970s set the stage for steadiness in - investment, industrialization, local consumption, exports and revenue generation.

Today, China – an economy with GDP of above \$5 trillion has a constrained public debt of merely \$347 billion, a favorable trade surplus of \$190 billion, and a minimal budget deficit of \$109 billion. Remarkably, China also maintains the world's largest accumulated sovereign funds, foreign reserves of \$2.648 trillion. These encouraging set of macro-economic indicators enabled China to ward off global effects of financial crisis easily, alternatively catering to its local consumption, in wake of low export targets. Deficit financing worked for China – it shored up on extra public spending, as its public finances remained stable throughout. The stimulus measures or deficit financing, expects to increase China's public debt barely by 3% of their GDP, without creating any burden.

China's efforts to overcome the effects of economic downturn are much more commendable and sensible, than any other country in the world. While most countries spend billions on bailing out banks and financial institutions to improve indirect liquidity for markets, China has offered direct employment and money circulation in the markets. China embarked upon the most sensible of deficit financing.

Pakistan

Learning from economies that have led the world, Pakistan still has an opportunity for introspection; to strive to balance the macro-economic indicators, instead of leaning towards unnecessary deficit financing and with overall reliance on our own revenue generation.

From mid 2008, Pakistan started registering an imbalance in its overall economy, a trend that kept up till 2nd quarter of 2010. By end of 2008, Pakistan's fiscal deficit increased from \$5.6 billion to exceed \$8 billion. Trade deficit increased from \$13 billion to exceed \$18 billion. By November 2008, the foreign reserves had fallen to \$6.5 billion. Instead of taking stock of the situation and implementing concrete measures, the government of Pakistan took the easy option, shoving the country towards adversity.

Pakistan was forced to approach IMF in a bid to help bail out its finances – to deficit finance the economy. The initial package with IMF was of \$7.6 billion, which was later increased to \$11.3 billion in 2009. Other than the IMF tranches, Pakistan sought the help of several Multi-lateral and Bi-lateral financiers, which in return, increased its external debt & liabilities (EDL) to \$54 billion by mid of 2010, from \$41 billion in January 2008.

Pakistan also tried floating sovereign bonds, another form of deficit financing - the Euro and Saindak bonds worth \$2.2 billion in FY09. Countries that have unpredictable inflation and varying exchange rates, with respect to their own currencies, often issue sovereign bonds in foreign currencies. This then creates the grave danger that in case the countries are unable to afford or repurchase the foreign currency bonds according to the specified timetable, chances of sovereign default become high. Such countries are further shunned by investors and as a double whammy, the foreign debt increases.

In the view of the fact that both of the above measures taken with international capital markets, were not sufficient to overcome Pakistan's self-created economic woes, the government was compelled towards deficit monetization, the third form of deficit financing. Pakistan's current government has relied heavily on domestic borrowings, the result of which has been, yet again, disparity in the debt dynamics. Moreover, this domestic borrowing stimulated record-high inflation of 24% in mid of 2008.

Pakistan's domestic debt multiplied, from Rs.2,610 billion in FY07 to become Rs.4,490 billion by end of March 2010. This augmentation in the total domestic debt stock took place mainly in the 'Floating Debt', secondly in the 'Unfunded Debt' and thirdly in the 'Permanent Debt'. By the

end of March 2010, Pakistan's domestic debt stood at \$53.2 billion, which was approximately 30.6% in percent of GDP.

All this deficit financing has turned out to become a futile exercise, unsuccessful in bringing about the desired results and unable to stimulate the economy towards any positive direction. By mid 2010, Pakistan had a total Public debt of around \$100 billion; is already paying annual Interest Payments of \$5.6 billion and total Debt Servicing has exceeded \$7.6 billion annually – expected to exceed \$10 billion after the 2010-11 fiscal year.

The situation now is that in essence, Pakistan is raising debt to repay debt, with little or no impact on the overall condition of the economy.

It's amusing to notice that the first IMF loan tranche was of \$3.1 billion and during that same quarter, the government had to repay \$3.65 billion as debt servicing. In the 2010-11 budgets, an amount of \$10.3 billion has been kept for debt-servicing purposes, with an increase of 7% compared to previous year's estimates. This again contributes to Pakistan's budget deficit.

The government has to pay \$10 billion every year till 2015 under the loan segment. Pakistan's 'clever' Finance Manager Mr. Abdul Hafeez Sheikh has already announced that further IMF follow-up programs can be subscribed to, in order to repay the original sought debt. What does it concern him or anyone else in the government. In all likelihood, they will be gone ensconced somewhere abroad, while the Pakistani Awaam will continue to pay the price.

For Pakistan, this seems to be a never ending vicious cycle. Deficit Financing is never an ideal approach, nor to be dragged on unnecessarily.

Deficit financing - works only if there are concrete plans and sound policies, with a long term vision of how to spend the money that is raised through debt, generate revenues and with an actionable plan as to how to repay that debt. To achieve these aims - honest, sincere, competent and committed governors are required, which Pakistan does not have. Under these circumstances, all we are doing is increasing our debt and raising the liabilities for our future generations to pay off. The money that should have been used to invest in the people and future of Pakistan has been and continues to be used to serve state expenditure on burgeoning and bloated bureaucracy, foreign visits, corruption, and extravagant personal expenses of the government functionaries.

Today, Pakistan's debt situation is alarming. We have no viable plans to raise sustainable and steady revenue, and no viable specific plan to reimburse and settle off the accumulated external and domestic debts. There are very few choices to make - hard and purposeful decisions.

What can be done?

To initiate that positive chain reaction and kick-start the economy, with the intent to bring constancy to its macro-economic indicators, Pakistan has to formulate policies that are consistent and productive. Few strategies that Pakistan could adopt shall be discussed below. However, without some fundamental reforms the technical strategies may not work.

The Socio-Behavioral Change in the Governance Culture

Of all the things that need to happen, this is the most urgent, fundamental, and foremost. No strategy, no tactic, no policy will work or be implemented in earnest, until either our governing class stops its rent seeking behavior, where they are always looking at short term personal gains without any regard to the country or its people. Alternatively, we get new a class of governors who are selfless, honest, and dedicated to the country and its people. Personal greed, nepotism and financial corruption that have become the hall mark of our governing elite will never let any meaningful strategy and policy to be either developed or implemented. Therefore, nothing that we suggest below will happen – can happen - without the personal efforts of our governors.

Rule of Law

This is the second most fundamental change that needs to happen. This is also the litmus test for the changing behavior of our governing elite. Without the proper implementation of rule of law, no economy can thrive. Our governing class needs to lead by example. Only the rule of law will ensure that business and economy thrives, policies and procedures are implemented, security and peace returns to this country, the justice is delivered which shall cut the root basis of extremism and terrorism. Above all, there is no better way to attract the investors from world over than to build their confidence with proper policies and procedures, enforced by the will of people through rule of law.

If the world knows we are law abiding nation, it will be easier to even raise debt, reschedule it, attract foreign investment, attract direct business with Pakistani entrepreneurs, facilitate business, reduce inflation and hence make the living much easier.

After these two fundamental reforms have taken place, the rest will follow. Nevertheless, being honest and proper is not enough. To reverse the decline we are in, following strategies and actions will provide a starting point.

Curtailing of Expenditure

All unnecessary expenditure should be frozen and fiscal strictness should be enforced. Austerity measures have to be strictly adopted by all and sundry. The total outlay of budget for 2010-11 is Rs3,259 billion that has risen from the budget of Rs1,874 billion in 2007-08. In 2007, the federal government expenditure was estimated at Rs1,353 billion. This rise in expenditure is neither justified nor complimented by the dismal performances of the various government ministries, divisions and commissions. Their contribution towards enhancement of exports or local consumption has not registered any improvement or significant growth. All such augmented government expenditure should be curtailed. Severe pruning of the highest order is needed.

Accountability and Transparency

According to Transparency International 2010, corruption in Pakistan has increased to a level of Rs223 billion compared to Rs195 billion in 2009. Pakistan's rank has moved up in list of most corrupt countries to rank at 42. Transparency, elimination of corruption and sincere intentions to overcome challenges – are present day requirements for Pakistan.

Unfortunately, Pakistan currently faces mismanagement, misplacement of economic priorities and corruption.

Implementation of Tax Reforms and Immediate Broad based Tax Collection

In Pakistan, the most unfortunate culture that has taken precedent, is that no one wants to pay taxes, leading to a stifled economy. While this is true throughout the world that everyone wants to pay as little tax as possible, there are two established traditions in the developed world. First, Taxation is recognized as a social responsibility with public imperative. Second, while Tax minimization techniques are used within the ambit of law, Tax avoidance is looked upon with disdain, considered a social and state crime.

In Pakistan, the situation is reverse, where tax avoidance culture is not unique to a certain class. The Prime Minister, the chief ministers, top politicians, bureaucrats, including its finance minister, and its elected parliamentarians are those that dodge their national duty.

It's quite unfortunate that only 3.34 million out of the 170 million nationals are registered taxpayers, from which 2.7 million are active tax payers, which makes it 1.5% of the population. In India, around 4.7% of the population; in developing countries like Argentina, around 16.5% and in first world countries like France, 58% of the population pays taxes.

In the 2010-11 budgets, the targeted tax revenue is Rs1.78 trillion and non-tax revenue is targeted at Rs632.2 billion. Pakistan needs to increase the revenues by at least twice the amount being collected, by broadening of tax base and uniformly implementing it over all provinces.

The government did initiate several measures to increase the tax base, but superficial and selected implementation, failed to achieve the preferred base. Political influence, insincerity of the audit firms, corruption within the taxation department and pressurizing tactics by influential citizens leaves very little space for potential improvement.

The new taxes under discussion are the 'Flood Tax' and the VAT. Flood tax should not be considered as an unpleasant proposal, provided that it too is implemented on a uniform base, across board and the aim is well defined. It should however, not be applied on properties of 500 sq yards and the basic limit for taxation should be set on properties of 2000 sq yards and above, in order to shield ordinary residential houses and the middle class. Similarly, VAT if replaced by GST, with proper documentation and objectives, should be welcomed; however, the conditions should be formulated by the Pakistani government and not through IMF.

The most important should be the imposition and collection of Agriculture tax in Pakistan, if we need to collect revenues on large scale basis. Agriculture contributes around 25% to the GDP and pays tax of around 1%.

Lastly, swift reforms within the taxation system should be encouraged - practices established, documentation perfected, multiple taxation system terminated, self assessment schemes promoted and leakages rectified – for long term economic revival. Tax administration should be organized, corruption eliminated, and proper audit persuaded.

Exploration of Large Natural Resources and attract Foreign Investment

Large scale projects related to exploration of natural resources in collaboration with foreign governments, potential investors and trans-national programs are crucial to uplift the economy, when capital is required to fund the economy. This one of the best options to invite capital,

create jobs, alleviate poverty and accrue long term benefits from the natural resources. Foreign Investment is one of the essential channels needed to attain durable and sustained growth for any economy.

The most promising aspect of Foreign Investment, other than the requisite capital, is its capability to mobilize foreign expertise, organizational management, knowledge based resources, technological superiority and utilization of established quality and security practices.

Pakistan has confirmed 185 billion tons of reserves of Coal - equivalent to atleast 850 trillion cubic feet (TCF) of Gas and 500 billion barrels of Oil – confirmed by Chinese and Russian feasibility studies. These reserves compete the riches of Saudi Arabia, are world's second largest reserves after USA's 250 billion ton reserves. Using only 2% of these reserves Pakistan can generate 20,000 MW of electricity for around 40 years.

Pakistan also has major reserves of Copper and Gold, discovered in Rekodiq in early 2006 which ranked Rekodiq amongst the world's top seven copper reserves. Pakistan has proven reserves of Iron ore around 1000 million tons.

Pakistan may have to allow access and grant rights to foreign companies and to those potential investors initially. Carefully crafted agreements with binding clauses for social and infrastructure development plans can ensure benefits for the future generations. Corporate social responsibility is the buzz word in the developed countries. There is no reason that corporations seeking to make billions will not invest millions in the education, healthcare, transportation and telecommunication sectors of the region they are working in. A renowned case in study, Saudi Aramco, the world's largest producer and refiner of petroleum, was American owned in 1933 and remained so till 1980. Ultimately, Saudi Arabia benefitted from its exploration activities and today stands to shine out amongst the OPEC. Pakistan's deliberate initial initiatives shall have to be similar.

Privatization Process

Pakistan should immediately sell off its loss accumulating Public sector enterprises or curtail their expenditures, unless an improved, reorganized and restructured program is launched. These loss making enterprises causes an additional burden on our budget of Rs235 billion (\$2.78 billion) and contributes towards the \$8.1 billion fiscal deficit.

Subsidies Limited or Specifically Targeted

Subsidies provided in the annual budget of 2010-11 are to a tune of Rs229 billion (\$2.71 billion) which were Rs114 billion (\$1.35 billion) in the budget of 2007-08. In ordinary circumstances, subsidies support. However as a short term measure, due to the current deficit and debt crisis Pakistan is enduring, targeted withdrawal can be considered. Once Pakistan emerges out of the looming circumstances, subsidies could be bestowed targeted to the poor classes. However if the expenditures are reduced this measure may not need to be taken at all.

Debt Rescheduling or Writing Off

Pakistan should request the friendly countries (FoP), financial institutions, Paris Club and Multi-lateral financiers to write off the debts or reschedule them to another 30 years. This shall allow Pakistan some fiscal space to reorganize and put into practice reforms. Alternatively, it could also be requested that the interest on the principal amount is written off. Rescheduling is always better than begging!

Debt servicing of external debt & liabilities (EDL) till March 2010, of FY10 amounted to \$4.3 billion, from which \$335 million was paid to FoP. This payment to FoP is more than a third of the amount received from them (FoP) in post-floods humanitarian assistance. Some help!

Overseas Pakistani contribution

Pakistan should seek the immediate help of overseas Pakistani, requesting them to come forward and donate generously – other than the foreign remittances they are officially contributing. However, this trump's card could be played by leadership that has credibility and reputation, which unfortunately, most of our leaders lack. Unaccountability and fraud in 'Qarz Utaro Mulk Sanwaro' and freezing of Pakistan's \$10 billion foreign reserves, under the government of PML-N were examples of day-light robbery – a depressing demonstration.

Conclusion

Moving on – an effort should be made to acknowledge and learn from the positive economic decisions undertaken by the developed countries. Perhaps, the scale and years of deficit financing did not bring about the fruitful results, nevertheless, economic decisions to invest in targeted programs, did reduce unemployment to a large extent. When President Obama announced his stimulus package of \$800 billion, he promised to seek additional funding from the Congress to fund some \$50 billion infrastructure plans, in a bid to build roads, railways, and airports – in addition to the initial investments. This plan would see 150,000 miles of roads and 4,000 miles of railways built in the next six years.

Similarly, China's stimulus programs boast of a gigantic infrastructure spending program that would cover 10 major areas, including projects aimed at environmental protection and technological innovation. As announced in 2008, stimulus spending worth \$600 billion was directed largely at funding bullet trains, nearly 100 airports, wind turbines, dams, highways, and bridges. About \$54 billion were dedicated towards rural infrastructure projects to create employment. According to The Wall Street Journal, China's road system will stretch 53,000 miles by 2020, topping the 47,000 miles of roadways in USA.

The most wise of all men, has been the newly elected Prime Minister of Japan, Mr. Naoto Kan, who in his first major speech acknowledged that unless a major financial restructuring was carried out and if Japan does not tackle its colossal debt, it may face a financial crisis and collapse like that of Greece. He admitted that it's difficult to sustain a policy that relies too heavily on issuing debt. Years of borrowing has increased Japan's Public debt to \$9.7 billion, almost twice its GDP.

Deficit financing should never be the cause to multiple public debts, without causing equal stimulus to generate revenues.

Saudi Arabia another aspiring nation and an inspiring example, pumped up money from its huge foreign reserves of \$443 billion, to keep up growth in the economy, maintain liquidity in banks and increase government spending. Saudi Arabia has also initiated new infrastructure projects – roads totaling 6400 km added to 35,000 km of roads under construction, ports, airports, railroads and postal services. In health care, above 92 hospitals are being built. For education system, new projects include 1,200 new schools in addition to some 3112 schools under construction, and rehabilitation of some 2,000 existing schools.

Similarly, UAE has the world's largest investment authority, created out of its own foreign reserves, for any future bailouts - some were applied to bailout Dubai's conglomerates.

An emerging economy like Pakistan, unless sufficient in foreign reserves and revenue generation, in addition to a stable currency, in relation to trade deficit and fiscal deficit, will unfortunately face serious imbalances in macro-economic indicators, obstructing stable growth opportunities.

Deficit financing is always a short term solution, to give life support to economies for a brief period. They should never be considered durable, nor prolonged beyond a measured end

product, unless certain that recoveries plan shall be as effective and enable the economy to strive back. Conversely, long term solutions to balance the macro-economic indicators should be drawn up and implemented. Reforms should be practical, long-standing and effective.

WHO WILL BELL THE CAT?