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The Deficit Saga: Part 1

The expansionary fiscal policy of the Government of Pakistan is being criticized due to the resulting fiscal deficit which has been on the rise since FY04. It is generally accused of building inflationary pressures further by stimulating demand and putting an upward pressure on the interest rates by increasing the government's funding requirements.

This paper begins by explaining the basic principles of government expenditure and the resulting deficit before examining the different attitudes present in economic literature regarding the negative impacts of these deficits. It then proceeds to deduce what should be the nature of expenditure growth in the developing economies to contain the negative impacts of fiscal deficits.

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Tales from Pakistan

The Pakistani economy continues to gain ground as strong aggregate demand reinforces economic growth. However, it faces increasing risks especially in terms of rising current account deficit and high inflation. While in order to alleviate the inflationary pressures, the State Bank of Pakistan has assumed a tight monetary posture, the government on the other hand has resorted to an expansionary fiscal policy. This has invited considerable criticism from various circles as it is said to further compound the risks to the economy.

On the one hand expansionary fiscal policy is said to exacerbate inflationary pressures by stimulating demand while on the other it is criticized for increasing the economy's fiscal deficit. During FY06, the expansionary fiscal policy resulted in increasing the total expenditure by 25.5%. This overshadowed the strong growth of 19.6% in revenue causing the fiscal deficit to GDP ratio to increase from 3.3% in FY05 to 4.2% in FY06. Typically the rising fiscal deficit is seen as increasing the government's funding requirements, putting an upward pressure on interest rates. It is largely due to these risks that are associated with expansionary fiscal policy, that concerns are being raised regarding the need to reform the fiscal policy to lean against the prevailing economic wind to control the building pressures.


However one must pay heed that the extent to which any of these risks materialize depends largely upon the nature of the expenditure growth and the mode that the government chooses to finance its fiscal deficit. For this reason disciplining fiscal management must focus on reforming the expenditure patterns and executing the most suitable financing policy rather than suppressing the fiscal expenditure.

From this point onwards this issue shall explain the basic principles of government expenditure and fiscal deficit while examining the different attitudes present in economic literature regarding the negative impacts of fiscal deficits. It then proceeds to deduce what should be the nature of expenditure growth in the developing economies to contain negative impacts of fiscal deficits.

Who needs the Government?

The fiscal balance is essentially the difference between the government's total receipts and the total expenditure. A fiscal deficit results when the government expenditure exceeds the government receipts and is often expressed as a percentage of GDP.

Government expenditure is often classified as capital expenditure and revenue expenditure. The former includes expenditure that leads to creation of assets whereas revenue expenditure does not involve asset creation and is recurring in nature.




Whether the government expenditure takes the form of capital or revenue expenditure, it typically focuses on providing public goods and services that are defined as goods that are non rival and non excludable. This implies that the consumption of the good by one individual does not reduce the amount of good available for consumption by others and that it is not possible to exclude others from consuming the good. It is this nature of the good that makes its production complicated. This is best explained by the following example: Consider the case of a resident who hires a security service to patrol his street. This will not only provide safety to his house but to all other houses on the street despite him being the only one paying for the service. The other people living on his street are said to be *free-riding* on his provision of the security service. There is nothing that he can do to inhibit them from obtaining this benefit other than cutting out the service altogether. If everyone on his street were to contribute for what would be the optimal level of security service, there would be inevitably some people who would not contribute anything and there would be others who would not contribute their fair share. Thus relying on the group to privately provide this public good would mean that too little of it would be supplied. The free riding problem necessitates the government to step in to the role of providing these public goods. The government then must determine the optimal amount of the public good to be supplied and should be able to collect the funds to finance it. In economic literature the best tool defined to fund public expenditure is that of taxation. Taxation can take many forms including taxation of personal and corporate income, value added taxation and the collection of taxes on specific sets of goods. Subsequently taxes are the most significant constituent of the government revenue/income.

Doing away with the weaknesses?

From the previous section it is evident that a fiscal deficit essentially implies that the respective government is unable to collect enough taxes to meet the expenses incurred. For example in case of Pakistan the rising fiscal deficit to GDP ratio witnessed since FY04 has been a result of growth in expenditure exceeding the growth in tax receipts.

Like external deficits, it is critical to contain fiscal deficits to ensure macroeconomic stability within the economy. Hence before the fiscal deficit reaches an unsustainable level, the government that does not have the immediate tax revenue to fund its expenditures resorts to either the capital markets or the central bank to borrow the necessary money.¹ Whether the government chooses to borrow from the capital markets or the central bank, it increases the risks for the economy in terms of rising inflation and rising interest rates as explained below.

¹ Governments can also finance their deficits through privatizations proceeds and international aid. However since the local government cannot determine the volume of these inflows, they are not treated as a readily available mode of financing.



The government borrows money from the capital markets by issuing securities, either Treasury Bills or Treasury Bonds. These securities are obligations compelling the government to repay the borrowed amount at maturity and also to pay interest in the form of coupons at specific points in time. This means that if a government borrows too much money, it has to pay a great deal of interest every year in order to service that debt. This represents money that could have been used to pay for public spending instead. Hence by borrowing money, the government has placed a greater emphasis on spending in the present than in the future; it has discounted the value of future expenditure.


An important risk associated with government financing via release of government bonds, is that an increase in interest rates across the market can occur. This is because increased government borrowing puts downward pressure on bond prices and subsequently interest rates rise. This draws the available capital away from prospective private investments to the government. Additionally the higher demand for credit created by the government in the financial markets causes the disposable incomes to decline. As a result private investment is crowded out.

However it must be noted that the extent to which the government can borrow via issuance of securities depends largely on the current savings within the economy. In case of low savings the borrowing government must sell its obligations to foreign investors. By doing so, the government makes itself vulnerable to the shifting and often volatile sentiment of the international capital markets. Indeed, with an excessive debt policy the government finds itself crippled by high interest rates and poor liquidity.

Another mode through which the government can finance its deficit is by borrowing from the central bank by printing more money. In economic literature government borrowing from the central bank is defined as inflationary in nature. This form of deficit financing—printing money is known as seigniorage. When the government chooses to finance the deficit through monetary creation rather than public borrowing, inflationary pressures build up within the economy. This often occurs when there is insufficient demand for the government debt as investors refuse to buy government bonds. This is often the case in less developed nations whose governments are considered too risky to attract investors willing to lend out of fear of default. Therefore monetary creation is often the only alternative available to the government to finance spending.

Tales from India

As seen in the earlier section, policy action to finance fiscal deficits results in inflation, high interest rates and subsequently low private investments. As a result the general view perceives fiscal deficits as inherently negative.



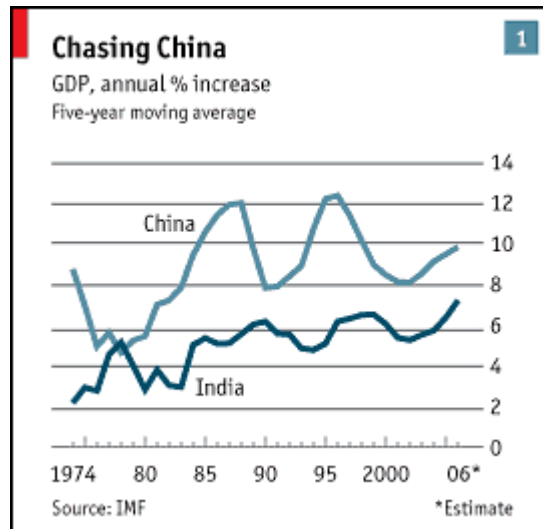
Originally this view gained strong ground when the British Treasury expressed the need to balance the government's expenditure with its income under all circumstances and not incur any fiscal deficit. This theory traced its roots from the perception that in any economy there is at any time only a certain pool of savings, and that if more of it is used for home investment then less becomes available for foreign investment, or if more of it is used for public works financed by government borrowing, then less is left over for private investment and foreign investment. It follows then that the government expenditure can never really increase total employment in an economy since the increase in employment brought about by government expenditure would be exactly counterbalanced by the reduction in employment arising from reduced private and foreign investment. In the wake of this concern the British colonial government in India, pursued deflationary policies even during the years of the Great Depression owing to the fall in its tax revenue. This worsened the impact of the Depression on the Indian economy and reduced the industrialization prospects which the policy of protection of the inter war period had opened up.

A significant variation from this view was later proposed by Keynesians who argued against the concept of fixed pool of savings. If the government expenditure is increased via employment of hitherto idle resources then it shall stimulate output and growth without necessarily increasing prices. As a result higher incomes and higher savings will be generated. Thus a corollary of this view is that if the government expenditure expands to generate employment of unutilized resources then an equivalent amount of savings would accrue in private hands. This shall result in an increase in tax revenues and the fiscal deficit will finance itself. On the other hand for an economy already running near full capacity, fiscal stimulus is damaging. This is because though it might improve economic growth by increasing output beyond potential, it shall exacerbate inflationary pressures. Hence the British Treasury view implicitly assumes that there are no idle resources within the economy and that it is operating at its full employment level. This view holds stronger ground in the case of developed economies.

An interesting picture emerges if the British Indian setting is contrasted with that of the current economic scenario which has built up over the last few years as it actually questions if not destroys the pre Keynesian view.

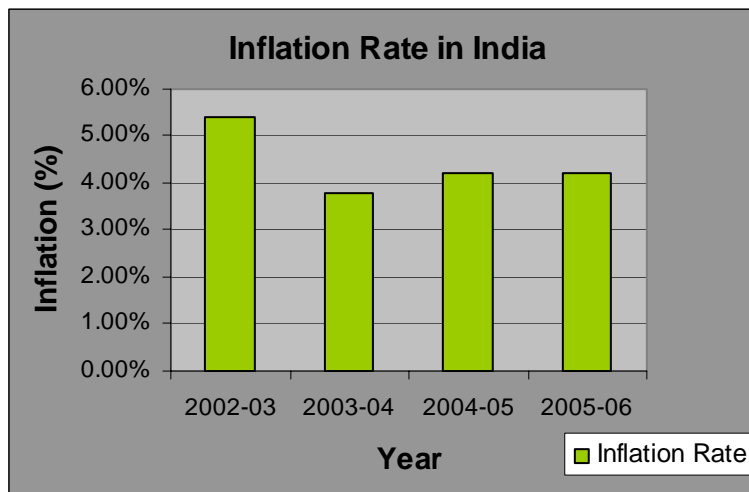
India has been running deficits of around 7.5% in the recent past, but has never been close to an economic crisis. In fact, the economy has been growing persistently at over 8% in the past four years compared with around 6% growth in the 1980s and 1990s and a measly 3.5% growth recorded during the three decades before 1980. India's year on year growth rate is expected to hit double figures at some point in 2007, and the country may even grow faster than China for at least one quarter.


Figure 1: The GDP growth of India relative to China



Though the inflation has been increasing in the past reaching the 6% level it is said to understate the degree of overheating. Besides, higher inflation has been associated more with supply side shocks than demand pull factors. Key industries face capacity constraints and severe skill shortages have caused wages to rocket. Hence the fiscal-deficit led inflation argument loses ground here. Additionally there have been no significant signs of crowding of private investment.

Figure 2: Inflationary Trend in India





Foreign investment on the other hand is motivated more by returns rather than the fiscal deficit. As a result, foreign institutional investors are making a beeline for investment into the Indian markets as foreign direct investment and portfolio investment increases despite the rising fiscal deficit.


Therefore, the economic fears generated by fiscal deficits have not really led to a constriction in economic activity as assumed by conventional economics. It must be noted that the Indian tale is not really singular. Germany, France, Italy and Japan have also been running prodigiously high fiscal deficits and do not indicate an impending crisis.

Quality Quality Quality: Never waver from it!

The above cases in points imply that economic theories that define fiscal deficits as inherently bad carry little weight. In fact in order to assess the negative impacts of fiscal deficit it is best to examine specifics regarding the kind of expenditure that the government incurs. For example if the government expenditure is meant to deal with a severe recession, to help self-defense, or focuses on public investment like infrastructure, education, basic research, or public health then the vast majority of economists would agree that the deficit is bearable, beneficial, and even necessary. If, on the other hand, the deficit results from wasteful expenditure or current consumption, then it is best to resort to tax hikes, or/and cuts in government purchases to balance the budget.

What is most important is that the government must spend the borrowed money in a constructive manner. In the case of emerging economies where economic output is substantially behind the optimal output, it is best to direct fiscal expenditure in tapping the unutilized resources of the economy. In this manner increased government expenditure will not result in rising prices; rather it will generate higher incomes and subsequently higher savings and tax revenues. Additionally the government must spend the revenues on development expenditure such as building roads and dams. A significant portion of the expenditure must be allocated to education and health. Such expenditure improves the standard of living of the people, and hence, their productivity. And this, in turn contributes to the national income improving the country's economic growth. As long as expenditure is increased in these areas, the resulting fiscal deficits are not bad per se.

However it must be noted that deficits cannot be allowed to reach unprecedented levels under any circumstances. For example in the case of India, though fiscal deficit does not impose any significant risks currently (as explained earlier), if it continues to rise further the increasing need to finance it shall erode future revenues. Again, the concern is not that India's public borrowing causes a financial crisis. Most of it is funded through domestic, not foreign debt and controls on capital outflows ensure that domestic savers



buy government bonds. The real problem is that India's weak fiscal position constrains its future growth by leaving no room for more public spending on infrastructure, education and health.

Similarly Pakistan's fiscal deficit is in itself not bad as long as the expenditure is concentrated on development infrastructure and utilizing the idle resources. This will increase incomes and the overall economic activity; in turn it will mean an increase in tax revenues and subsequently relax the pressures of rising fiscal deficit. Hence the best way to assess Pakistan's fiscal deficit is not by looking at the absolute numbers but by examining the constituents of government expenditure and analyzing how efficiently the expenditure contributes to the overall economic activity.

In our next Quid Pro Quo which will be a sequel to this, we will address this question, discussing in detail the current nature of public expenditure in Pakistan and how it needs to be reformed in a way that results in enhancing economic activity enough so that it overshadows the negative impacts of fiscal deficits.



Economic Snapshot

Fiscal year 06														
Units	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec	
<u>Inflation</u>														
Headline Inflation	%	8.51	8.76	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.88	8.88
Core inflation	%	7.36	7.34	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.5	5.50
Food inflation	%	8.1	8.17	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54	12.71	12.71
Non-food inflation	%	8.8	9.18	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.22	6.22
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.09	8.10	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.64	8.64
6 month	%	8.25	8.29	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81
12 month	%	8.77	8.75	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00
<u>External Sector</u>														
Export	Mln US\$	1,451	1,252	1,287	1,536	1,432	1,498	1,512	1350	1383	1420	1290	1448	1532
Import	Mln US\$	1,929	2,037	1,854	2,269	1,664	2,299	2,626	2370	2292	2450	2191	2121	2201
Trade balance	Mln US\$	(478)	(785)	(567)	(733)	(232)	(801)	(1114)	(1020)	(909)	(1030)	(901)	(673)	(669)
Remittances	Mln US\$	336	391	339	444	401	507	464	376	435	422	410	448	475
Forex reserves	Mln US\$	11,669	11,505	11,516	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,960



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