

Budget deficit and borrowing

M A Taslim

"The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist." J. M. Keynes.

There is a rising concern about 'excessive borrowing' by the government in recent months. In just about 5 months it has borrowed Tk 213.21 billion from the banking system (as of 4 Dec 2011), which is 12.5 per cent greater than what the Budget 2011-12 had provided for the entire fiscal year. Unless the government can put a sudden stop to borrowing, this portends of a large build-up of a budget deficit during the rest of the year. A large deficit will have both fiscal and monetary ramifications for not only the current fiscal year but also for the future. Some of these, such as rising inflation, taka depreciation and a worsening balance of payments, are already evident.

However, the government is not happy about the disquiet among economists and others about the large scale domestic borrowing. The Finance Minister had some harsh words about economists and media. The Prime Minister also admonished them in a recent meeting: "the government does not "eat ghee" with the borrowed funds; these are spent for the development of the nation." An implication that could have percolated to the lower orders of the government is that it was alright to borrow and spend so long as the spending is for 'national development', and not for conspicuous consumption.

The PM's comment is actually in line with an old economic theory. There is a large group of economists who subscribe to the view that the government should spend generously, if necessary

by borrowing, to stimulate the economy. They are generally known as Keynesian economists after the name of John Maynard Keynes who was one of the most influential economists of the last century. Interestingly a very similar view, known the Real Bills Doctrine, was the guiding principle of the US Federal Reserve Bank's monetary policy during its early years until it was discredited by the events of the 1920s.

Keynesian economics was an attempt to rescue the capitalist world from self-destruction during the Great Depression of the 1930s by advancing an almost painless antidote, i.e. spend and spend more. It resonated like sweet music in the ears of the politicians, and when implemented worked well in a depressed world with huge unused capacity. By the 1960s, economic policies in many countries were influenced by Keynesian economics.

The limits of Keynesian policies were anticipated by a group of economists led by Milton Friedman who argued against excessive government intervention in the economy. In their view the market would find its own equilibrium. Government intervention, apparently beneficial, could only worsen the situation in the long term. The limitations of Keynesianism became evident as the excess capacity of the depression era was gradually worked off and the economy returned to near full employment. The real jolt came with the first fuel oil crisis of the 1970s.

With the oil crisis a new economic phenomenon, termed stagflation, i.e. inflation with stagnation, afflicted the western world which was not fully understood. Keynesian prescription, followed in many developing as well as developed countries, only worsened the situation by increasing inflation but doing little to raise output or employment. On the contrary unemployment soared in many countries. A new intellectual strain, later named

new classical economics, emerged that challenged the central tenets of Keynesianism and advocated for less government intervention. It had considerable influence on western economic policies since the 1980s.

However, Keynesian economics that offered a large role to the government in economic management did not lose appeal, at least in the developing world. Many governments had become addicted to vigorous economic activism; they found it difficult to let go. It continued have its sway in these countries with adverse consequences.

A favourite argument of economists of this genre is that if government invests for productive purposes (say for energy and infrastructure), the average productivity of the nation will rise and hence income will also rise in future. The higher income will help ease the inflationary bias of the higher spending and also help pay off the debt.

The argument is persuasive; however a few things should be borne in mind. Investments are made well before, sometimes years before, the increased output would be forthcoming. Moreover, several taka of investment is needed to generate an additional taka of output. Hence, the impact of increased productivity and output will not be evident for a while after the investment is made. Meanwhile, investment spending has to be balanced by domestic saving if a build-up of an excessive aggregate demand pressure is to be avoided.

If domestic saving is not adequate to cover the intended additional investment by the government, it will necessarily crowd out private investment. The latter is regarded by many as more efficient than government investment, and if so there could be a net loss in output rather than a gain. More importantly, a dynamic private sector may vigorously compete with the public sector for funds, and in the process bid up the interest rate and prices. An inflationary spiral may ensue.

If the government borrows from the central bank, i.e. it finances its investment by printing money, the monetary base increases correspondingly unless offset by other components of reserve money. The inflationary spiral could become more intense in this case. Only if the government is able to borrow overseas and most of the investment is done by imports, the impact on prices would be less.

Finally the need for productive investment does not end; one set of productive investment gives rise to a need for another. A government that has become used to high spending finds it very difficult to wind down even when it is widely recognised that a pressing need for public investment is no longer there. In other words, once the government is in, it is in for a long haul.

When the government's usage of funds exceeds the revenue it borrows either from the public, or the banking system or from overseas sources. The public is currently not in a mood to lend to the government because of the low rates of return on government saving instruments. The government collected only Tk 4.98 billion from this source during the first quarter (only 6.0 per cent of the budget target). The commercial banks are reported to be short of liquidity. Nonetheless government borrowed Tk 84.8 billion (as on 4 Dec 2011) from mostly state-owned commercial banks severely stressing their balance sheets. It will not be advisable to put them under undue stress.

The government is also borrowing money from the central bank on a large scale. The major part of its total borrowing (60.2 per cent or Tk 128.41 billion) is actually from Bangladesh Bank. This is not a healthy development, and could get out of hand if the government does not reduce its borrowing spree.

Borrowing money from the central bank or printing money raises revenue for the government. It is akin to a tax on the people, but not as transparent as other taxes such as income tax. Raising revenue by

printing money is fraught with danger if the safe limit is exceeded. A desperate government usually exceeds the limit by a large margin. The consequence is runaway inflation as witnessed in several countries of Latin America during the second half of the last century. The latest in the list of hyperinflation countries is Zimbabwe where a bankrupt government tried to keep itself afloat by printing money endlessly. The ensuing inflation ran at an astronomical rate of billions of per cent. This is of course not to suggest that Bangladesh is anywhere near such a situation, but it is well to keep the experiences of other countries in mind.

Foreign borrowing is usually a large source of funds for budget implementation, especially for development projects. The Finance Ministry had optimistically assumed that Tk 236.23 billion of foreign assistance would be available to cover the financing shortfall. However, negotiations with the traditional donor agencies for the release of the promised funds seem to have suffered serious setbacks. It now seems unlikely that a large amount of foreign assistance would be available. This would place additional pressure on the domestic sources unless the government downsizes its ambitions.

The economy would not probably have run into the difficulties it is currently facing if the government had not undertaken some ambitious and costly projects, even though these might have been 'productive', without a full consideration of all aspects of their financing. In particular, its attempt to solve the long-standing electricity problem in a very short time through very costly private rental power plants was an ill-advised solution. Although the government seems to have belatedly realised the real risks of this adventure and apparently decided to go slow on it, the rental power plants already contracted for will bleed the government and the nation for a long time.

The government may avoid the fiscal burden of subsidies to run the rental plants, but only by shifting this burden to the hapless public who will have to pay through the nose for the quick solution of their electricity problem. The government has already raised fuel oil and electricity prices very substantially under the crushing pressure of the burgeoning subsidies. Further increases shortly are quite certain.

Spending beyond means will lead to a larger public debt, which will entail greater debt service obligations. Interest payments used up 15.3 per cent of the total government revenue last year. These will rise considerably in the future years leaving less money to spend for other purposes. The administrative and political imperative to spend for these other purposes may force the government to borrow even more, thus entangling the economy in a debt spiral. The plight of some European economies that are now caught in a vicious debt spiral should be a pointer to the folly of borrowing too much.

A number of economic indicators are moving in the wrong direction. The world economy is slowing down, and its impact on the external sector is now apparent. The government should pay heed to these alarming signals. The economy can still be steered away from a full-blown crisis, but this will require a very careful assessment of the current situation, the design of an appropriate policy response and a proper implementation of the policies. Without prejudging what such policies might be, it seems fairly certain that the government would be required to rein in its ambition to a manageable level.

The writer is professor at Department of Economics, Dhaka University.

BB launches call money market for Islamic banks

Bangladesh Bank recently introduced a call money market -- Islami Interbank Fund Market — for the shariah-based banks and financial institutions and Islamic banking branches of commercial banks.

A BB circular issued on the day said that the IIFM where shariah-based banks and FIs and branches of other banks would lend or borrow money among them for one-day, would facilitate strengthening of liquidity management of the banks.

The transaction of money will be based on profit instead of interest.

Although the Islamic shariah-based banks have got about 20 per cent market share of the total asset and liability in the banking sector, they had no inter-bank shariah-based market.

In the conventional call money or overnight money market, the commercial banks make direct transactions with other banks. But in case of a shariah-based call money market, the banks will transact with each other through a separate fund – Islami Bond Fund.

The BB circular said that the banks, FIs and Islamic branches of commercial banks could handover their excess funds to Islami Bond Fund on daily basis. The Islami Bond Fund would take the fund as custodian. Any Islamic bank requiring fund will borrow the money from the IBF.

‘The profits on money invested from the IBF, which would be accumulated on daily basis, would be distributed among participants on a temporary basis in proportion with their capital in the fund,’ said the circular. The profits would be adjusted in the year-end in proportion with the profits declared by the borrower bank.

The circular said that all transactions would be based on Mudaraba.

BB executive director SK Sur Chowdhury said that the IIFM would help ease the existing liquidity crisis of the shariah-based banks. ‘The shariah-based banks have been demanding for the market for long.’

BB officials said in recent times, small-scale shariah-based banks and FIs faced liquidity crisis despite having Tk 3,000 to Tk 4,000 excess liquidity with the shariah-based banks. ‘These small-scale banks cannot go to other banks to borrow money as the banks charge interest. Islami banks do not transact on interest-based funds,’ said an official.