

Options for Financing the Budgetary Deficit, Money Supply, and Growth of Banking Sector

A. R. KEMAL

The fiscal deficit has assumed alarming proportions in Pakistan; it was as large as 8.5 percent of the GDP in 1987-88. Though it has fallen somewhat in recent years, yet it still is around 6.7 percent of GDP. While the fiscal deficit was expected to result in a high rate of inflation and slow growth of output, Pakistan has sustained a high growth rate of output with price stability. This makes Pakistan a fascinating case study.¹

The impact of the fiscal deficit on monetary expansion, growth of output and price stability in various countries has been extensively analysed. For example, see Cline (1987); Collins and Park (1989), Corbo (1985,1989); Corbo and de Melo (1989); Corbo and Nam (1988); Dornbusch and de Pablo (1989); Easterly (1989); Edwards (1989); Enders and Mattione (1984); Gil Diaz (1988); Haque (1987); Kim and Yun (1988); Kormendi (1983); Modigliani and Sterling (1986); Nash (1988); Ocampo (1987); Reisen and van Trotsenburg (1988); van Wijnbergen (1987) and Yellen (1989). However, very little work is available on Pakistan. The present study is an attempt to fill that important gap.

By analysing trends in the budgetary deficit and in the pattern of financing the deficit, the present study explores their implications for the interest rate structure, monetary expansion, and growth of the banking sector in Pakistan. The paper is divided into four sections. Section I traces the trends in the fiscal deficit over time. Patterns of financing the deficit and implications for monetary expansion are analysed in Section II. Section III examines the implications of changes in the rate structure of interest for the growth of money supply and the banking sector. Section IV presents the main conclusions of the study.

TRENDS IN THE BUDGETARY DEFICIT

The budgetary deficit increased from Rs 14.6 billion in 1980-81 to Rs 58.2

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¹That the fiscal deficits encourage a higher level of consumption at the cost of productive capacity in the future, of course, is the neoclassical view. Keynesians, on the other hand, believe that the budgetary deficits stimulate investment while the Ricardians believe that deficits have no impact on the savings and investment level. See Yellen (1989).

billion in 1989-90. The fiscal deficit would have had grown further but for the massive resource mobilisation and containment of expenditures in the last few years. Accordingly, the fiscal deficit which had grown from 5.3 to 8.5 percent of GDP over the 1980-81 to 1987-88 period, fell to 6.7 percent of GDP by 1989-90 (see Table 1).

The fiscal deficit has increased despite the fact that the growth of development expenditures was contained to 9.7 percent per annum; non-development expenditures continued to increase at a rate of 18.9 percent during this period. As a percentage of GDP development expenditures fell sharply from 8.6 percent in 1980-81 to 6.3 percent in 1989-90, while non-development expenditures increased from 14.5 to 19.7 percent. Even though public revenues also increased from 16.3 percent to 17.9 percent of GDP they were inadequate to finance the growing expenditures.

Table 1

Pakistan's Budgetary Deficit

Years	Overall Deficit	
	Million Rs	Percentage of G.D.P.
1980-81	14618	5.3
1981-82	17175	5.3
1982-83	25639	7.0
1983-84	25153	6.0
1984-85	36777	7.8
1985-86	41644	8.1
1986-87	46710	8.2
1987-88	57563	8.5
1988-89	56879	7.4
1989-90	58917	6.7

Sources: Economic Survey, 1987-88 and 1990-91. Government of Pakistan.

II. FINANCING OF THE FISCAL DEFICIT

Each of the three modes of financing the fiscal deficit viz. external borrowing, domestic non-bank borrowing and bank borrowing have different implications for the growth of money supply and crowding out of the public expendi-

tures. The importance of each type of borrowing in financing the fiscal deficit has varied significantly over time (see Table 2).

The proportion of external resources in financing the fiscal deficit fell from 47.7 percent in 1980-81 to 14.1 percent in 1984-85 but in the recent years it has once again increased sharply. External financing has three important implications. First, it allows the government to run a fiscal deficit without any crowding out of the private expenditures. Second, by enhancing the availability of goods in the country, external financing enables price stability despite the huge fiscal deficit. Third, the external financing, on average, carries lower interest rates than that carried by domestic borrowing and, as such, the burden of debt servicing is relatively smaller.

Table 2
Trends in Financing of Budgetary Deficits

Years	Percentage Share in Financing the Deficit				
	Overall Deficit	External Financing	Domestic Financing	Non-bank Financing	Bank Financing
1980-81	14,618	47.7	52.3	36.2	16.1
1981-82	17,175	31.1	68.9	36.8	32.1
1982-83	25,654	20.1	79.9	56.0	23.9
1983-84	25,147	19.9	80.1	48.8	31.3
1984-85	36,777	14.1	85.9	35.0	50.9
1985-86	41,644	20.6	79.4	64.5	14.9
1986-87	46,710	18.0	82.0	58.5	23.5
1987-88	57,563	22.0	78.0	53.7	24.2
1988-89	56,879	32.0	68.0	66.6	1.4
1989-90	58,917	41.7	58.3	52.3	6.0

Sources: Economic Survey, 1986-87 and 1990-91. Government of Pakistan.

Inadequacy of external resources in financing the fiscal deficit has led to heavy reliance on domestic resources for financing the deficit. By offering high interest rates on its financial instruments, the government increased its net non-bank borrowings from Rs 5.3 billion in 1980-81 to Rs 40.5 billion in 1989-90.

Bank financing, in the second half of the Eighties, has been no more than 15 percent of the fiscal deficit and in recent years it has essentially been from the commercial banks. The net government borrowing from the State Bank which

amounted to Rs 16.3 billion in 1984-85, declined by Rs 7.1 billion in 1985-86. In the following three years they increased but only by Rs 10.7 billion. On the other hand, the borrowings from the commercial banks declined sharply from Rs 3.8 billion in 1980-81 to Rs 0.5 billion in 1983-84 but increased sharply to Rs 26.5 billion in 1987-88. The government borrowings from commercial banks may have mostly substituted the credit to other sectors. The banks had to make the substitution because the Government pursued a tight monetary policy which did not accommodate the bank's increased cash requirements, and because of the statutory requirement to maintain a certain proportion (currently 35 percent including 5 percent in cash reserves) of total deposit liabilities in liquid assets, particularly cash and government securities. The reserve requirement can only be met by holding cash and government securities (Treasury Bills) with low yields ranging between 0.5 and 6.5 percent. This increases the overall cost of funds to the banks and as such tends to raise the lending rates. However, this did not happen in Pakistan due to controls over the banking sector leading to lower profits for the banks and the depositors.

The distinctive features of the Government's non-bank borrowing policy include: (i) a heavy reliance on short-term securities;² (ii) higher interest rates on public debt instruments than on bank deposits;³ and (iii) for almost half of the non-bank financing, tapping the resources of captive institutions such as banks and non-bank financial institutions and insurance companies at low interest rates ranging between 0.5 percent to 6 percent.

III. TERM STRUCTURE OF INTEREST RATES IN PAKISTAN

In order to finance the large fiscal deficit in a non-inflationary way, the Government provided attractive returns on its financial instruments. This had a ripple effect on the whole interest rate structure leading to serious distortions in the rate structure with serious implications for the level and composition of investment.

The three forms of financial instruments, viz. deposits with the commercial banks; investments in the national savings schemes; and the bonds, securities and debentures issued by the government and other public sector organizations, differ

²76 percent of domestic debt currently is of short-term maturity compared to 45 percent in the mid-1970s.

³For about half of the outstanding debt, the rates are higher than for bank deposits (e.g., 12.5-15 percent tax-free for a six month certificate compared to 8-10 percent taxable return on a six month bank deposit.

in return, risk and maturities and have different implications for cost of debt servicing, monetary expansion, and levels of investment in the country.

Rates of return on bank deposits (except time deposits for less than six months and for a period ranging between four to five years which declined since 1983-84), have shown remarkable stability (see Annex Table 1). The differentials in rates of return on deposits of maturities ranging between 2 years to less than 5 years have narrowed down but in the returns on deposits of 5 years or more and for shorter maturities have widened. Moreover, the proportion of deposits yielding higher returns have increased.

The rate of return on advances also show wide dispersion (see Annex Table 2). The rate of return on export finances and locally fabricated machinery is 6 percent and on the advances to the small farmers it is 8 percent; the banks have mandatory credit targets for these types of loans. (For details of concessionary credit, see Annex Table 3.) The commercial banks are allowed to charge any mark-up ranging between 10 to 20 percent on trade-related modes of financing. Even though for investment related financing, there is no ceiling on the rate of mark-up (there is a lower limit of 10 percent), the commercial banks, despite excess demand, continue to advance loans at 13 percent. The average rate of return on advances is around 11 percent which falls considerably short of the rates of return on bank deposits of longer maturity (see Annex Tables 1 and 2).

National Saving Schemes, especially of longer maturities, carry higher returns than the returns on bank deposits (see Annex Table 4). They also have three additional attractive features. Firstly, incomes from these financial instruments are completely exempt from income taxes. Second, the rate of return on financial instruments of National Saving Schemes is pre-specified while it is uncertain on the bank deposits. Third, the holders of Defence Saving Certificates are allowed a rebate in income taxes.

The rates of return offered by National Saving Schemes exceed by 8.3 to 30.8 percent the rate of return on time deposits held with the commercial banks depending on the financial instruments and the maturity (see Table 3). The maximum differential exists for the shortest and the longest maturity while the differential is relatively smaller on maturities of three to five years.

Whereas a very little differential existed in the rates of return on bank deposits and on National Saving Schemes upto 1979-80, the increase in the rate of return on Defence Saving Certificates effected in 1980-81 created big differentials in the rates of return offered on two types of instruments in later years. The growing differentials in interest rates offered by commercial banks and Na-

Table 3
*Differential in the Rates of Return of
 Commercial Bank Deposits and National Saving Schemes*

	One Year Maturity	Three Year Maturity	Five Year Maturity	Seven Year Maturity	Ten Year Maturity
1979-80	0.59	- .22	+ .68	1.58	1.78
1980-81	1.52	0.57	1.47	3.37	3.57
1988-89	3.72	1.05	1.18	3.08	3.28

tional Saving Schemes have serious implications for the growth of time deposits held with the commercial banks (see Table 4). Time deposits held with the commercial banks have grown at the rate of 11.0 percent. In comparison, the investments in National Saving Schemes registered a growth rate of 32.2 percent. Consequently, the commercial banks which held 76.9 percent of total time deposits now account for only 40.7 percent of the time deposits held by both the commercial banks and the National Saving Schemes.

Table 4
*Comparative Shares of Commercial Banks and
 Saving Schemes in Time Deposits*

(1)	Time Deposits Held with Commercial Banks (2)	Accounts and Certificates Held with National Saving Schemes (3)	Share of Commercial Bank (2)/{(2) + (3)} (4)
1979-80	30,435	9149	76.9
1980-81	31,061	10,266	75.2
1981-82	35,584	13,477	72.5
1982-83	49,483	20,929	70.3
1983-84	59,822	28,977	67.4
1984-85	64,937	39,247	62.3
1985-86	76,280	52,885	59.1
1986-87	80,398	69,930	53.5
1987-88	84,374	93,136	47.5
1988-89	77,695	113,041	40.7

Source: State Bank of Pakistan, Annual Report (Various Issues).

The diversion of deposits from the commercial banks to the National Saving Schemes has essentially been instrumental in containing the money supply. It

may be noted that while money supply, defined as M2, increased at the rate of only 13.2 percent the money supply, defined as M3, grew at a rate of 17.5 percent (see Table 5).

Table 5
Money Supply

End Price Stocks (Last Working Day Basis)	Narrow Money (M1)	Monetary		Broad		
		% Change	Assets (M2)	% Change	Money (M3)	
1980-81	73.56	18.66	104.62	13.2	116.80	13.2
1981-82	80.93	10.0	116.51	11.4	133.87	14.4
1982-83	96.54	19.3	146.03	25.3	176.68	32.0
1983-84	103.45	7.2	163.27	11.8	206.90	17.1
1984-85	118.97	15.0	183.91	12.6	238.87	15.5
1985-86	134.83	13.3	211.11	14.8	277.63	16.2
1986-87	159.63	18.4	240.02	13.7	330.87	19.2
1987-88	184.97	15.9	269.34	12.3	392.50	18.6
1988-89	204.33	10.5	282.03	4.7	423.37	7.9

Source: Economic Survey, Government of Pakistan.

IV. CONCLUSIONS

The main conclusions emerging from the study are as follows:

- (i) The fiscal deficit which had assumed alarming proportions in 1987-88, has since then fallen from 8.5 to 6.7 percent of GDP in 1989-90 through containment of public expenditures and domestic resources mobilisation;
- (ii) The importance of external resources in financing the fiscal deficit declined in the first half of the Eighties but increased once again in recent years;
- (iii) By relying more on non-bank borrowing than on bank borrowing Pakistan has been able to realise a respectable growth rate of output accompanied with a moderate rate of inflation;
- (iv) Bank financing in the second half of the Eighties, on average, was no more than 15 percent of the deficit and has largely come through borrowings from commercial banks;
- (v) The instruments of public debt are not only as liquid as the deposits with commercial banks, they also have higher yields and other benefits

- such as tax exemptions and tax rebates;
- (vi) The large differential in the interest rates offered by commercial banks and those by the National Saving Schemes has resulted in a sharp decline in the share of commercial banks in time deposits held by them;
 - (vii) Because of the diversion of deposits to National Saving Schemes, the monetary expansion, conventionally measured in Pakistan (M2) grew at a rate of 13.2 percent. On the other hand M3 grew at a rate of 17.2 percent; and
 - (viii) The rapid growth of money supply (M3) accompanied with moderate inflation can be attributed to three factors. First, non-commercial bank deposits are not good substitutes for commercial bank deposits in terms of liquidity. It calls for a study on the proper definition of money in Pakistan. Second, a sharp fall in velocity of money. And third, part of the increase in the monetary expansion has been offset by increase in output in the underground economy.

Annex Table 1

Annexures

Rates of Return on Deposits

	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
Current Deposits	0.10	0.11	0.04	0.02	—	—	—	—	—	—
Call Deposits	5.73	5.33	5.82	6.26	5.51	5.40	4.44	4.96	3.19	3.21
Other Deposit Accounts	3.47	3.79	4.00	4.51	4.69	3.79	3.90	2.53	2.65	2.69
Saving Deposits	7.58	7.57	7.60	7.64	7.61	7.63	7.61	6.98	7.30	7.44
Deposit for										
Less than 6 Months	8.89	9.39	9.61	9.19	9.29	8.79	7.89	7.69	7.24	7.39
6 Months to Less than										
1 Year	10.15	10.43	9.84	9.91	9.93	9.69	9.04	6.34	8.24	8.41
1 Year to Less than										
2 Years	10.41	10.48	10.34	10.49	10.53	10.38	9.41	6.08	8.11	8.28
2 Years to Less than										
3 Years	11.06	11.19	11.06	10.76	11.10	10.95	10.53	10.10	10.58	10.80
3 Years to Less than										
4 Years	11.82	12.03	12.02	11.84	11.79	11.58	11.38	11.72	11.31	11.55
4 Years to Less than										
5 Years	11.82	12.03	12.31	12.39	12.54	12.40	11.91	11.98	10.50*	10.73*
5 Years and Over	11.82	12.03	12.37	12.44	12.47	12.41	12.03	12.20	12.08	12.32
Average	6.18	5.95	6.05	6.24	6.39	5.76	8.80	7.07	7.67	7.83

Source: Annual Report, State Bank of Pakistan (Various Issues).

* These fall short of average return on deposits of shorter maturity because these deposits have largely concentrated in banks declaring relatively low profits.

Annex Table 2

Weighted Average Rates of Interest on Advances

	Precious Metals	Stock Exchange Securities	Merchandise	Fixed Assets Including Machinery	Real Estate	Financial Obligations	Others	Total Advances
June, 1978	11.01	12.13	12.93	11.45	11.15	12.85	11.43	11.80
June, 1979	8.58	12.61	12.12	11.53	10.79	12.06	11.00	11.62
June, 1980	7.91	11.90	11.48	11.50	10.60	12.11	10.54	11.09
June, 1981	6.73	12.73	11.41	12.02	0.73	12.13	11.13	11.20
June, 1982	13.15	12.66	10.84	11.82	10.38	7.85	10.38	10.72
June, 1983	13.26	11.85	10.94	11.88	10.16	7.98	9.77	10.55
June, 1984	13.52	10.59	11.61	12.22	10.13	7.76	9.69	10.83
June, 1985	13.11	11.22	10.89	12.16	10.44	9.67	9.29	10.49
June, 1986	12.92	10.76	11.76	12.80	10.90	9.04	9.30	10.91
June, 1987	11.40	10.80	11.19	12.63	11.00	11.02	9.70	11.00
June, 1988	11.03	11.50	10.79	13.00	10.52	8.76	9.15	10.70
March, 1989	11.92	11.36	11.30	13.25	10.52	11.15	10.08	10.78

Source: Annual Report, State Bank of Pakistan (Various Issues).

Table 3
Concessionary Credit to Private Sector

	(Rs in Million)			
	1985-86	1986-87	1987-88	1988-89
I. Commercial Banks:				
(a) Under Export Finance Scheme	+ 1,338	+ 3,353	+ 2,491	- 65
(b) Under LMM Scheme	+ 97	+ 77	+ 128	+ 111
(i) Local Sales	- 11	+ 83	+ 179	+ 68
(ii) Export Sales	+ 108	- 6	- 51	+ 43
(c) Return-free Agricultural Production Loans*	+ 618	+ 1,625	+ 214	- 842 *
II. I.D.B.P. (Under LMM Scheme)	+ 177	+ 229	+ 236	+ 220
III. SBP Credit to NBFIs (Under LMM Scheme)	+ 795	+ 1,266	+ 864	+ 560
Total (I + II + III)	+ 2,310	+ 4,848	+ 3,591	+ 715
IV. Total Credit to Private Sector	+ 19,355	+ 21,252	+ 21,799	+ 18,183
V. Ratio of Concessionary Credit to Private Sector (in Percentage)	11.94	22.81	16.47	3.93
VI. Total Credit to Private Sector by Commercial Banks	+ 22,941	+ 22,022	+ 22,992	+ 15,891

Source: Annual Report, State Bank of Pakistan (Various Issues).

*Return-free as well as at a mark-up of 8 percent.

Annex Table 4

*Rates of Return on National Saving Schemes
Instruments in 1988-89*

	Compound Rate of Return
Defence Saving Certificates	
One Year Maturity	12.0
Three Years Maturity	12.6
Five Years Maturity	13.5
Seven Years Maturity	15.4
Ten Years Maturity	15.6
National Deposit Certificates	
One Year Maturity	12.0
Seven Years Maturity	14.6
Khas Deposit Certificates	
Three Years Maturity	13.4
Mahana Amdani Accounts	
One Year Maturity	12.1
Five Years Maturity	14.9

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Comments on
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Supply, and Growth of the Banking Sector”

The increased severity and incidence of macroeconomic crises in developing countries during the past decade or so has attracted much research attention to the causes, consequences and cures of macroeconomic imbalances. There is more and better appreciation of the importance of fiscal policy for macroeconomic stability and of such stability for economic growth and development. What makes for successful adjustment to a crisis though, has proved to be both more elusive and controversial, particularly once countries get into deep crisis. While Pakistan had avoided getting into a severe macroeconomic crisis—certainly by contemporary Latin American, African or East European standards—the economy has been faced with the threat of one and the need to undertake adjustment to avoid getting into a deep crisis. Relatedly, Pakistan has also embarked on a reform of the financial sector. Hence, A. R. Kemal’s paper addresses highly topical issues both in the general literature and for policy-making in Pakistan.

In examining the pattern of financing of the growing fiscal deficit in Pakistan during most of the 1980s, and many of its varied consequences and correlates, A. R. Kemal throws up a number of stimulating and interesting questions for further research. Much of the paper is necessarily speculative, reflecting the paucity of policy relevant research on Pakistan in the area. Kemal’s paper points to the need for and the policy relevance of research in such matters as the appropriate definition of money for financial programming purposes in Pakistan; the determinants of interest rates; the operation of the financial or banking sector and financial intermediation; the links between the formal and informal credit markets; the adequacy of national accounts (not just in terms of capturing the “underground” economy); private sector saving behaviour and the relationship between the public and private sectors as mediated through the budget.

Kemal makes a number of stimulating observations and poses a rich variety of hypotheses to be investigated in these and other areas. However, the distinction between the formulation of a hypothesis and the provision of research results does tend occasionally to get a trifle blurred in the presentation. Thus, for example, what happened to interest rates in the “Kerb” market or whether, exactly when, how and the extent to which the private sector was squeezed out by the

financing of the fiscal deficits remain rather more in the nature of hypotheses than research results.

On the crowding out of the private sector, the story in Pakistan seems to have been rather more complex than Kemal allows. Arguably, the high interest rates on domestic debt instruments—the so-called National Saving Schemes—stimulated private savings rather than simply substituting private investment for public expenditures. Thus private savings and investment rose substantially during the 1980s. (Of course, a more efficient financial sector offering higher returns on say bank deposits would have been a more efficient way of raising private savings without the financial disintermediation that Kemal highlights.) Also, more recent research has emphasized that private investment and public expenditures can be not only substitutes but also complements. Thus certain public investments, e.g. on infrastructure, can crowd-in rather than crowd-out private investment.¹ Ultimately though unsustainably large fiscal deficits, even if they are not crowding out the private sector for “longish” periods, force adjustment and, if that is excessively delayed, lead to a macroeconomic crisis.

Kemal observes that “the main feature of Pakistan’s deficit financing policy has been its success in avoiding inflationary effects” while allowing for reasonably rapid growth of output since heavy recourse to non-bank borrowing limited monetary expansion. Now, each of the three forms of financing a fiscal deficit creates problems in terms of one or more macroeconomic targets if the deficit is excessively large. Thus foreign borrowing creates an external debt crisis, bank borrowing results in inflation and domestic non-bank borrowing squeezes the private sector.² These are the direct, short-run consequences and Kemal focuses on the squeezing out of the private sector by the form of financing adopted in Pakistan. But he neglects important intertemporal consequences: over-time the pattern of financing created a fiscal problem. Thus, interest payments on domestic debt have been, by far, the fastest rising component of budgetary expenditures (at 30 percent a year between 1979-80 and 1989-90) and by the late 1980s debt servicing was hovering at around 40 percent of current expenditures. The Government found itself in a domestic debt trap with more and more of its borrowings going simply to pay the interest on domestic debt. The unsustainability of the deficit meant that its financing ultimately threatened macroeconomic stability and growth.

¹See, for example, the recent study of stabilization episodes in 18 countries under the aegis of WIDER, whose results are summarized in Taylor (1988).

²For an exposition of the consequences and trade-offs of different forms of financing the fiscal deficit see for example, Bruiter (1985); Chhibber and Khalilzadeh-Shirazi (1988); Fischer and Easterly (1990).

An important lesson of experience has been that unsustainable deficits ultimately tend to get monetized if adjustment is delayed beyond a point [Cf. Fischer and Easterly (1990)]. Government have a strong tendency to resort to printing money when they run up against the limits of non-bank borrowing.

Hopefully, the invitation to further research in Kemal's stimulating paper will prove irresistible to economists working on Pakistan.

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