Deficit finance and developing economies:Implications and results

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Implications and results

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Abstract

This article discusses briefly various aspects and forms of deficit financing in modern economies. It deals with deficit financing (i) within countries and (ii) between the member countries of the International Monetary Fund (IMF} and that institution as aid provider to a member in difficulty. In (i) it elaborates on the use of deficit financing as an instrument to part fund development, role in crisis management and inflationary consequences. In (ii) it briefly sees deficit financing on a global scale, explain IMF conditionality and the sort of programs it envisaged the aid seeking members to follow; it presents illustration and critique of the instrument each case.. In conclusion it contains some observations including a few policy suggestions.

Key words: Deficit financing, Economic development; Inflation; IMF conditionality; financial turmoil

JEL Codes: E 30 E31 F 35

A. Introduction – technicalities

Deficit finance – government spending more than its income - belongs to the fiscal policy area of modern governments. It can be used for various purposes. There may be situations when deficit financing becomes absolutely essential. For example, to finance war-cost during the Second World War, massive deficit financing was made.[1] However, this paper shall largely remain occupied with the rationale and consequences of deficit finance in developing countries to push growth or manage financial turmoil.

The concept of a deficit in budget is not as simple as it looks. Various versions of deficit may be noted:

1. Budget deficit = total expenditure – total receipts
2. Revenue deficit = revenue expenditure – revenue receipts
3. Fiscal Deficit = total expenditure – total receipts except borrowings
4. Primary Deficit = Fiscal deficit- interest payments
5. Effective revenue Deficit = Revenue Deficit – grants for the creation of capital assets
6. Monetized Fiscal Deficit = that part of the fiscal deficit covered by borrowing from the Central Bank[2]

Deficit may refer to any one or more of the above narratives in a fiscal policy analysis. Thus, specification is always better for clarity. Using the first concept –budgetary deficit - may especially be deceptive as it may conceal the contribution of borrowings to total receipts of the government.

A better and purposeful definition of the gap is provided by the *fiscal deficit* – total expenditure minus total receipt *excluding borrowings*. Fiscal deficit thus represents

[1] Deficit financing whether in war or peace is savings in real terms forced on the people by the creation of new money (Bhagwati 1956).

[2] See Indian Economy: https://www.indianeconomy.net/splclassroom/what-is-deficit-financing-what-are-the-different-types-of-deficits-in-the-budget/

government's loaning from the domestic market and is the best measure of budgetary health of a country.

The main factor that cause fiscal deficit in the budget is the revenue shortfall - the negative difference between revenue receipts and revenue expenditure in an accounting sense.

The government can bridge fiscal gap from three sources:

i. Mobilizing domestic savings through financial instruments like bonds or saving certificates. However, as the domestic savings pool is the same for different users and limited, if government gets more, private enterprise will receive less. Aggregate mobilization and its impact on growth may be inconsequential.

ii. Printing of new money is tempting and cheaper – unlike bonds no interest is payable. But its perils are no less than its attraction. It carries inflationary potential that may tend to get out of hand worsening income and wealth inequalities and depreciation of domestic currency. Figure 1 depicts this macroeconomics process Here, C, S, I and M represent the initial position of the variable and those with suffix p their *planned* locale.

iii. The third more commonly used source in the modern era is to borrow from abroad mostly from the international financial institution the IMF.

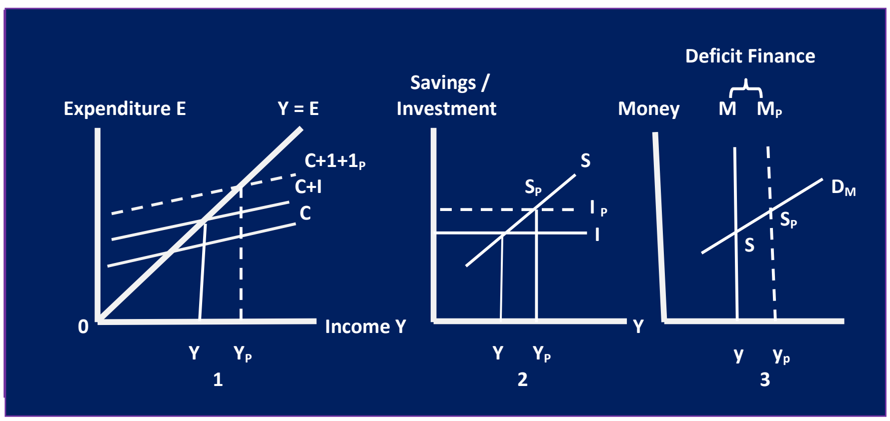

Figure 1: Macroeconomic savings gap for deficit financing

Economics of deficit financing

So far we have explained the technical aspects of deficit financing. Let us now look at its economics. Even as running budget deficits is not confined to developing economies, they usually tend to run high deficits as measures by the ratio of the debt of a country to its nominal GDP. A study by the World Bank found that if the debt-to-GDP ratio exceeds 77 percent for an extended period of time, it slows economic growth. Every percentage point of debt above this *tipping point* costs the country 1.7 percent in economic growth.[3] The ratio is a guiding tool for international investors in bonds for comparative default possibilities. For, it measures the *financial leverage* of an economy and can be compared for change overtime. Table 1 provides debt to GDP ratios for som selected developed and Muslim developing countries.

[3] It's even worse for emerging markets. There, each additional percentage point of debt above 64 percent will slow growth by 2 percent each year. Us economy 2015).

Table 1: National debt to nominal GDP ratio (%) of selected countries in 2017

Developing countries		Developed countries	
Lebanon	142..40	Japan	253.00
Egypt	104.40	Italy	131.80
Jordon	86.00	Switzerland	128.30
Morocco	77.30	Singapore	110.60
Pakistan	67.20	USA	105.40

Source: IMF

It follows from table 1 that countries with high incomes are having debt GDP ratios much higher than the *tripping* norm of 77%; they are living beyond their means due to their clout in global politics and power. But not a few Muslim countries in the reverse situation are in real trouble. The questions for seeking answers are: why the developing ountries run into debts they eventually find burdensome and how they can avoid the pitfalls?

Structure of the article:

The article is spread over six sections including the introduction. In the following section we explain how deficit financing is used as an instrument to mobilize resources for economic development citing the experience of India's first two five year plans. This we follow with a discussion on causes and implications of inflation, an inevitable consequence of deficit finance. After going through the role of deficit financing in crisis management, we raise the discussion to global level showing in bare bones how countries falling into non-manageable deficits to meet their financial obligation seek funds from the IMF as members to look back in hours of need. Here, we explain the term conditionality that has to be met for obtaining the needed assistance. We discuss the nature of programs falling under conditionality and evaluate them in the light of aid recipients' experiences. Finally, we close the discussion with a few concluding observations and suggestions.

Urge for growth

Some reasons are obvious. Centuries of colonial rule over now developing countries including Muslim lands had pushed them back from their glorious economic and cultural past. They had been converted into suppliers of raw materials minerals and work force for the development of manufactures in the ruling countries for which the colonies provided ready markets. During freedom movements people were motivated to rise in revolt against occupation on the promise of coming prosperity to remove squalor and misery. Independence that mostly dawned on the vanquished after the Second World War ignited the pant up urge for economic growth to make the change meaningful. The foreigners holding back the keys had left. Demonstration effect overtook. Expanding means of transportation and communication, especially the internet resources and publicity converted the planet earth into a 'global village'. The living standards and material affluence of the West coming into observation and experience of people and leaders in developing economies awaken in them the urge to imitate; imitate anything and everything not always to advantage. In eagerness to copy the society segmented more and more into groupings, mainly the haves and have-nots. The desire to grow and grow fast, however, remained a common national aspiration. Financial resources being in short supply, deficit budgeting emerged as a potential source to augment cash requirements.[4]

Structure of the article:

The article is spread over four sections including the introduction. In the following section we explain how deficit financing is used as an instrument to mobilize resources for economic development citing the experience India's first two five year plans. This we follow with a discussion on causes and implications of inflation an inevitable consequence of deficit finance. We then raise the discussion to global level showing that countries falling into non-manageable deficits to meet their financial obligation and seek funds from the IMF as members to look back in hours of need. Here, we explain the term conditionality that has to be met for obtaining the needed IMF assistance. We discuss the nature of programs falling under conditionality and evaluate them in the light of aid recipients' experiences. We close the discussion with a few concluding observations and suggestions.

B. .Deficit financing experiment:

Interestingly, deficit finance can be used, and was in fact used in India, as a tool to mobilize resources during the 1950s.The financial resource estimate for the First Five Year Plan (1951-1956) of the country from taxation and borrowings at the centre and state levels put together showed a substantial shortfall from the requirements to meet the plan growth targets. This brought under consideration the possible use of a third source - deficit financing. The term according to the Planning Commission denoted the direct addition to gross national expenditure through budget deficits irrespective of being on revenue or capital account. In essence, the policy implied government spending in excess of revenues it collected from taxation, earnings of state enterprises, loans from the public, deposits and funds and other miscellaneous sources. The government could cover the deficit either by running down its accumulated balances, or by borrowing from the banking system – mainly from the RBI the Central Bank of the country.[5] Deficit finance at rupees 2900 million provided 7.5% of overall financial outlay (14% of the public sector) for the plan over the five year period.

The First Plan was designated largely to agriculture and irrigation; the second (1956-1961) aimed at industrialization and transportation, but agriculture got its due. Emphasis on expanding the public sector continued in view of the declared objective of establishing a socialistic social order. Emboldened by the success of the First Five Year Plan, the size of the Second Five Year Plan in outlay terms was raised to rupees 480 billion of which no less than rupees 120 billion or 25% was to be the deficit finance component.

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[4] Most classical writers were for a balanced budget and considered deficits unwelcome even immoral with the surprising exception of T. R. Malthus who considered internally raised debt innocuous.

[5] Borrowing from commercial banks in emerging economies is uncertain as credit creation by them is insufficient anf money markets are not well-developed.

The two plans raised the GDP of the country at constant prices by 42 % and per capita income by 18% despite rapid increase in population. 30 years were also added to the life expectancy of an average Indian. Laudable achievements these were wherein deficit financing contributed significantly as a tool for resource mobilization.

However, this merry march could not continue due to massive diversion of resources from development to defense after the 1962 Chinese attack across the North-Eastern border of the country.[6]

C. Deficit finance and inflation:

Deficit finance is a double-edged weapon that cuts both ways. If it facilitates resource mobilization say for development it can initiate and fuel inflation as well. Deficit finance adds to money supply and if the saleable output increases at slower rate, the additional money is not fully absorbed and must result in inflationary pressures via increase in demand.

To explain the inflationary potential of deficit financing, let us take a simple though crude illustration to explain the inflationary potential of deficit financing. We assume the velocity of money as unity. Let the number of goods available for transactions be 1000 units and the initial money supply with the public Rupees 2000, government having no money. Now the government wants to have half the output that is 500 units of goods. It neither taxes people nor borrow from them; it prints Rupees 2000 worth of currency notes. The total money supply impinging on the unchanged stock of goods would now be Rupees 4000. The price under competition of people with the government will push the price of the commodity to Rupees 4 a unit. At the new price the public with their Rees 2000 would purchase 500 units of the commodity; with their money the government would take away the remaining 500 units of the commodity either for boosting production or for wading war. Thus, deficit financing will force society in real terms 500 units the government would use unleashing inflation in the economy. Whatever the limitation of the Fisher's quantity theory of money it *has* this element of truth that reckless increase in money supply could play havoc with the economy via inflation.

The situation aggravates if money added fuels speculative activity. To ward off such possibilities effort is made to pull back the created money into savings' fold accompanied with a well managed system of price controls and rationing of wage goods. But such systems seldom remain clean; they more often than not tend to failure. Table 2 presents inflation rate rise in 2017. These rates are alaming in terms of their cumulative effect. From long term viewpoint not more than 1 to 3 percent inflation is considered manageable.

[6] It was debated for some time as to why did Chinese if they eventually had to withdraw voluntarily after reaching Tezpur in the Assam valley. Ayub Khan the ex-president of Pakistan provides the logic behind the action in his book *Friends not masters.* He thought that West had started comparing economic progress of democratic India with communist China. The latter attacked India to make them spend on arms too.

Table 2: Rise in rates of inflation 2017

Countries	Rate %	Countries	Rate %
Venezuela	488.86	Switzerland	7.0
Sudan	26.00	Kazakhstan	7.0
Turkey	24.52	Myanmar	6.5
Yemen	20.00	Sri Lanka	6.0
Nigeria	16.70	Malaysia	3.8
Iran	9.10	India	3.8

Inflation beyond a limit alters the relative price structures to the disadvantage of weaker social groups; it perpetuates income and wealth inequalities generating social injustice and deepens poverty. Wages stagnate, profits swell. And if profits rise faster than growth of output distributive inequalities and poverty aggravates even in developed economies. The question then is what gives rise to such high rates of inflation as table 2 shows. The situation has many imponderables but several factors are palpable. give rise to corruption and black markets. Thus, deficit finance has to be used, if at all, with utmost caution. India was lucky to contain inflation by good management and a bit of good luck. Things drastically changed for the worse on price front during the Third Five year Plan and after.

Causes of inflation

Top heavy governance: To the extent the revenue government raises through borrowings is not spent on producing saleable goods and services, it does not create the means for its repayment and is for that reason inflationary. Democracy despite being the best of all forms of governance fast becoming top-heavy in developing economies. The salaries and allowances of top functionaries – presidents, prime ministers, governors chief ministers members of parliament and legislative assemblies rise merrily without reference to the expansion rate of the economy. Their royal living styles are an exploitative burden on the public funds. This is now coming to light in a big way in the Islamic republic of Pakistan.

Corruption & bribes Swindling of public funds, grabbing public land, and rampant bribery involving billions in money are the defining characteristics of development in emerging economies. Projects at times are completed on paper without trace on ground. Much money was shown spent on border roads to strengthen defense preparedness in India. During the 1962 Chinese attack army was surprised to find no roads on ground clearly marked on area maps. The Seilla-Bomdella tragedy was the result. Costly projects are delayed indefinitely, their costs multiplying several times.

Inflation and arms race

A distinctive and privileged social class is thus created in a good measure through corrupt and exploitative practices to finance lavish living. Foreign loans taken in the name of development projects in part land in Swiss or Panama accounts of leader and the affluent. Can this all be stopped so that money is spent where it is meant to be spent? Imran Khan is trying to do it for building a Pakistan of his vision. Either he will soon give up or will achieve a miracle.

There is a wider and more sinister angle to the developed and developing economies divide in the world – the bloody wars – there is a chain from Vietnam to Afghanistan.

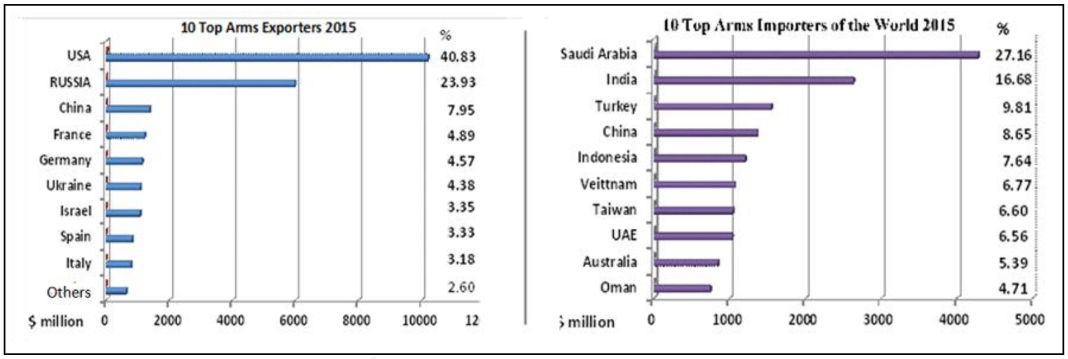

Figure 2: 10 top global Exporters and Importer of arms in 2015

Flourishing economies have been destroyed on the whims and imaginary fears of the powerful to attain more power. Arms trade is the most lucrative of all businesses; it values profit, not blood. A mere look at Figure 4 will make one understand the economics of war and peace.

Modern warfare is also a major contributor to international pollution. As per estimates released by the Council on Foreign Relations (CFR), in 2016 alone the US administration rained at least 26,171 bombs on seven different countries, averaging three an hour every day, every month, over the entire year. The figures, says the report, are relatively conservative, meaning the number of bombs dropped in 2016 could have been much higher. The report concludes that there was no legal validity for this action save through stretching the interpretation of an old authorization for the use of military force. Further, Trump admits that costly wars are responsible for the current economic troubles of the US, not the trade with Beijing.[7]

Thus, so long as wars – hot or cold – continue to fuel armament industry the distinction between developed and developing economies will persist. The desire of the less privileged to "catch up with them" will continue creating deficits providing business to the IMF – the world *mahajan* – the great money lender.

It is argued that inflation though perpetuates distributive injustices is better than depression. True, but if inflation gets out of hand there is little to choose between the two. Recall the German inflation of 1923 the consequence of the First World War. The economy was totally shattered by the crushing weight of the war reparations the Allied had imposed on the vanquished. Printing of notes was the only means to discharge obligations. In matter of days the price level of the country sky rocketed by as much as 10^{13}. See the details.

[7] Former French Prime Minister Dominique de Villepin, speaking at the Global Leadership Forum organised by Sri Sri Ravi Shankar's Art of Living Foundation, said, 'Military intervention is stupid, war on terrorism is stupid. The global leadership has been wrong in responding to Afghanistan, Iraq, Libya and Mali.' He said that the world needs new weapons of peace and not weapons of war (*Times of India*, 13 March 2016).

Table3: Exchange Rates: German Mark / USD

Jan. 1918	5.21	Mar. 1923	21,190.00
Jan. 1919	8.20	Apr. 1923	24,475.00
Jan. 1920	64.80	May 1923	47,670.00
Jan. 1921	64.91	June 1923	109,966.00
Jan. 1922	191.81	July 1923	353,412.00
April 1922	291.00	Aug. 1923	4,620,455.00
July 1922	493.22	Sept. 1923	98,860,000.00
Oct. 1922	3,180.96	Oct. 1923	25,260,000,000.00
Jan. 1923	17,972.00	Nov. 1923	2,193,600,000,000.00
Feb. 1923	27,918.00	Dec. 1923	4,200,000,000,000.00

Source: Schools History –The seeds of evil: The rise of Hitler
(ASK.Com// Downloaded on 10.01.2011)

Figure 3

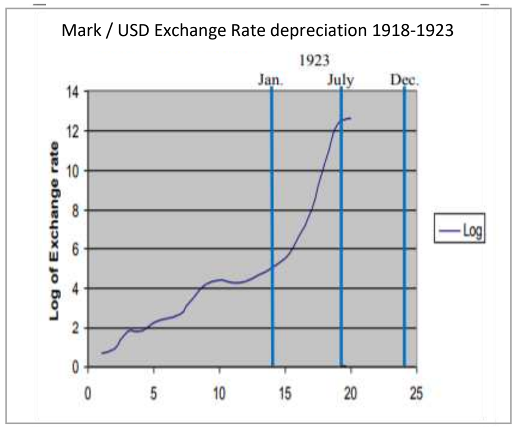

Figure construction is based on data of table 3

How can such devastations be avoided? There *are* ways to control and curb inflation and have at times been effectively employed. To ward off possibilities of getting inflation out of hand, effort is made to pull back the created money into savings' fold accompanied with a well managed system of price controls and rationing of wage goods. But such systems seldom remain clean; they more often than not give rise to corruption and black markets. Inflation beyond a limit – and such limit is soon reached – becomes a moral hazard issue. Only widespread moral and ethical reforms can alone save the day. From the savings investment disequilibria let us turn to deficits financial institutions suffer from during cyclical down turns and with them the whole community suffers.

D. Crisis management:

Deficit financing is macroeconomic phenomenon falling in the fiscal policy domain. J. M. Keynes vigorously advocated using deficit financing as an anti-crisis measure when the 1930s Great depression peaked and the wage rigidity for downward adjustment becoming the obstacle in the way of public remedial action (Keynes *General Theory*1936).

In the 1930s crisis deficit finance was needed to revive the falling demand to cheer up the gloomy markets; it was meant to create what Keynes termed as *effective* demand; the demand that could deliver. To this end, he advocated to employ people even for digging pits in the ground to put money in their pockets as wage and to employ them again to fill the same pits if needed and till needed. Thus, deficit financing mostly via printing money was the answer to the challenge; it was *internal* to governance, e.i. ndogenous to the country's macroeconomic equilibrium system.

This changed drastically during great turmoil the subprime crisis of 2007 unleashed across countries for years. The focus for deficit finance had shifted from revival of aggregate demand to the bailout of failing and falling of the giant financial institutions – banks, insurance companies and funds; ironically not *because* of depression, as in 1930s, but as *leading* to depression. The need was in a way alien to the macroeconomic systems.

The economy was no longer the recipient of help; it was the giver to the beleaguered players of the financial markets to save them from a complete annihilation of their assets; thanks to their greed and irrational exuberance. Institutions – banks, insurance companies and funds - were running into huge deficits to meet their liabilities. This deficit was made up by public funds; a new phase in fiscal policy.

A study by the Government Accountability Office (GAO) puts the 2008 financial crisis cost to the U.S. economy at more than $22 trillion. It further observed that the crisis was associated with not only a steep decline in output but also with the most severe economic downturn since the Great Depression of the 1930s," The agency said that the financial crisis toll on economic output could be as much as $13 trillion -- an entire year's gross domestic product. Furthermore, the paper wealth lost by the U.S. homeowners totaled to $9.1 billion while economic losses associated with increased mortgage foreclosures and higher unemployment since 2008 need to be considered as additional costs.[8]

How the crisis affected the Islamic financial institutions is a moot point even as an IMF survey lauds Islamic banks as being 'More Resilient to Crisis'[9] As a matter of fact, literature is full of praises for Islamic finance on that count ascribing the achievement to two factors: Islamic finance maintains its links with the real economic activities and is based on the principle of risk sharing. The claim of observed immunity might have elements of truth but it probably is being over stretched. We have shown elsewhere that some Islamic banks and financial institutions did come to grief during the crisis and that the crisis overtook them indirectly through its depressing impact on macroeconomic variables – savings, investment and output - across countries. Thus, one must take the superiority claims with a grain of salt.[10]

E. Deficit country bailout

So far we have been with how a country uses deficit finance as a matter between governments and economic entities for development or for crisis management. However, a much bigger drama of deficit finance is staged between a country and the international community operating through the International Monetary Fund (IMF) established for helping member countries out of financial deficits, if they land in, by granting them loans under a scheme containing the terms conditions for the proposed loaning contained in what is popularly known as the *conditionality.* To recall, borrowing is linked to the rising costs of monumental projects' or of crisis management. Both difficulties are of the countries' own making, natural calamities occasionally contributing.

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[8]Melendez, E. D of Huff Post US: https://www.huffingtonpost.in/entry/financial-crisis-cost-ao_n_2687553 It must however be noted that the costs exclude those in terms of output and wealth loss that the crisis inflicted on millions it impacted across the globe.

[9] IMF Survey on line: https://www.imf.org/en/News/Articles/2015/09/28/04/53/sores100410a

[10] See Hasan, Zubair: *Risk Sharing – the sole basis of Islamic finance? Time for a serious rethink,* KAU Journal: Islamic Economics, Volume 19, No. 2, section5, pp. 30-31

Reason apart, a country is not able to escape default on its external commitments and liabilities unless helped; the last source for needed being the IMF. The help seekers are usually the developing countries while the funds the IMF provides come from the developed countries, the institution acting as their collective *mahajan.*

IMF bailout loan is no charity; it has to be paid back in the common pool so that others in need could be helped. The conditions imposed are, therefore, tight. So tight at times that they make the patient bleed white. The IMF Greece bailout is a case in point. The pending case is of Pakistan who has approached the Fund for help under compelling circumstances. The country is neck-deep in foreign debt related to China Pakistan Economic Corridor the CPEC involving their $60 billion investment debt before Pakistan's application could be considered. Let us have a brief look at the manner the IMF conducts its bailout business and what repercussions it has on the borrowing nation, if illustrations are a guide.

The Conditionality:

Under the IMF conditionality mentioned above the member country seeking help has the formal responsibility for selecting, designing, and implementing the policies that will make the IMF-supported program successful. But the overarching goal is always to restore and maintain the balance of payments viability and macroeconomic stability while setting the stage for sustained, high-quality growth and, in low-income countries, for reducing poverty.[11]

For ensuring progress in program implementation and to mitigate risk to IMF provided resources, the loan granted is released in installments linked to demonstrable policy pursuit. The progress is reported to the IMF Executive Board for review to see if the program is on course or modifications are needed for achieving the prescribed objectives. The review approvals are based on various policy commitments agreed with the country authorities.[12]

A typical IMF program focuses on correcting the balance of payment problems of a country seeking bailout. Its main components are devaluation of domestic currency, liberalization of trade and expansion of the private sector. The three elements are assumed as mutually compatible and mutually supportive.

Currencies of developing countries are mostly over-valued relative to the IMF based parities.[13] The depreciating currency of these countries bears testimony to this statement.[14] The assumptions supportive of devaluation are that the act would make domestic goods

[11] Apparently this looks fair and nice However,, the needy must so frame the programs that they win the IMF approval. Commitment of these programs to free enterprise norms is obvious.

[12] For details see IMF Conditionality March 6, 2018: https://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/21/28/IMF-Conditionality

[13] In fact, most developing countries find it advantageous to keep if they can their currencies over-valued as their exports are not usually price elastic; they get imports cheaper for defense and development.

[14] Note that the depreciation of a currency is not the same thing as its devaluation. Depreciation is a market phenomenon where on currency depreciates relative to some other. Devaluation is the reduction in official equivalence in gold at the IMF. Thus, two currencies cannot depreciate relative to one another but both can devalue together at the IMF.

cheaper for the foreigners boosting exports, and imports costlier reducing their inflows. This combined with liberal trade policy would help correct the adverse balance of payments the borrowing countries suffer from. Since public enterprises lack motivation, are prone to corruption and slow to act, encouragement to privatization of the economy may be an added advantage for program implementation. The question is how valid are these assumptions?

Comment: The catch in this argumentation is that it ignores the issue of export and import elasticity. Most developing economies are exporters of primary products where price elasticity is generally less than one. To get the same revenue as before, the country must export more in physical terms than before. This apart, would they in all cases have an exportable surplus ready at hand? On the other hand, imports of these countries are even less price elastic. They import food grains to feed the teaming masses, machinery and spares for their upcoming industries and technical knowhow. They cannot cut down much on such survival needs. Devaluation for them ipso facto means – continue imports at the same even increased level and pay more. Debt servicing also becomes costlier. Corruption is not the monopoly of the public sector. Private sector across the globe is showing itself no less corrupt if not more if what caused the 2007 subprime debacle and what followed in its wake is an indicator. Thus, the IMF bailout programs may not always or entirely prove conducive or helpful to the seekers.

A recent comparative study of two countries dealing with financial crisis of 997-98 is both instructive and interesting. It was the massive short-term Western capital flight from South-East Asia that hit the flourishing economies of the region. Originating from Thailand, the contagion spread fast to other nations including Malaysia even as her economic fundamentals were sound. Thailand sought relief from the IMF while Malaysia took a different route – they resorted to the imposition of exchange controls.[15]

In a small open economy, like Malaysia, the flight of short-term capital during the 1997-98 crisis lead to a sequence of events involving the selling of shares by foreigners in the stock market and taking the sale proceeds to the currency market for buying the US dollars to be taken out, the process leading to a down turn in both the markets. The short-term capital account of the country recorded an extra-ordinary net outflow of funds – RM 11.3 billion in 1997, and 21.7 billion in 1998 (Bank Negara Report 1998, p.43). Probably bulk of this amount left the country during the sixty-three weeks of the crisis period.

The run on Ringgit - the Malaysian currency - led to a rapid depreciation (35%) in its value vis-à-vis the US dollar in months. Action had to be taken to stem the rot. For some time the country experimented with the raising of interest rates to arrest capital flight but it did not work. Eventually, Mahathir Muhammad that astute Prime Minister of Malaysia who knew that there was nothing wrong with the country's economy, took the monumental decision to impose, exchange controls rather than go to the IMF for bailout. For him, it was

[15] See Hasan Zubair (2002): *The 1997-98 financial crisis in Malaysia: causes, response, and results,* Islamic Economic Studies Vol. 9, No. 2, March in defense of Malaysian action

a liberalization versus liberty. The exchange rate was stabilized at RM 3.8 to a \$. The events unfolding in subsequent months vindicated the validity of his decision.[16]

Malaysia came out of the turmoil unscathed and faster than others in the region. The Economic and Social Survey of Asia and the Pacific of the UN released on April 4, 2001 declared: "The experience of Malaysia suggests that capital controls can help stabilize an otherwise difficult situation". IMF now envisages imposing fewer conditions on loans granted to developing countries so that they may have greater freedom to design their recovery plans in the future. The IMF made this announcement later in March 2013.

In contrast, after paying the last installment of the IMF loan in 2013 the Thailand Prime Minister vowed to never seek IMF bailout in future.[17] The lament of the prime minister was not without reason. The IMF conditionality framework *has* some inbuilt difficulties for the borrowers. The important ones are as follows.

1. Reduce borrowing – increase taxes cut expenditure.
2. Raise interest rate to stabilize currency
3. Let failing firms liquidate
4. Initiate structural changes including increased privatization, deregulation and reduction in corruption as well as in official delays in decision making.

These conditions not only betray an ideological bias,[18] the insistence on structural adjustment and the macroeconomic interventions they require often make the situation worse for the recipient country, not better.

F. Concluding remarks

Deficit finance refers to the act of meeting the shortfall in an amount of money from a specified target. For example filling the gap caused by lack of income to meet expenditure actual or targeted. It may also refer to meet deficiency in volume of assets to meet given liabilities measured in money. Thus, for a country, there can be a deficit in its balance of payments to be filled by advances from an external agency such as the IMF. We have dealt with both these cases and related issues in this article. We have shown how a country can use deficit finance as a tool for mobilizing physical resources to support plan targets.

On the global level, countries can run into massive debts which they at some stage find to have become liabilities they cannot meet on their own and approach IMF for assistance

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[16] The present author has suggest a package of measures involving exchange control to remedy the situation in a seminar at the IIUM in June 2008 when the crisis was in the making. He later defended the action against criticism tooth and nail. See Hasan Zubair (2003): *The 1997-98 financial crisis in Malaysia: causes, response, and results – a rejoinder,* Islamic Economic Studies Vol. 10, No. 2, March.

[17] Thaksin made the declaration on the national TV on August 1, 2003 after the last installment of debt to the IMF had been cleared two years ahead of time. <https://assassinationthaksin.wordpress.com/2013/03/24/thaksinomics-the-hero-of-thailands-financial-crisis-or-populous-madness>/

[18] The free market advocates criticize the IMF fot the interventionist component in its relief program and demand that the institution should not interfere in the free plat of demand and supply even in foreign exchange markets. Liberalization may especially be damaging in the least developed economies.

with a loan to bridge the gap. This assistance comes with what is known as conditionality. We explained the content and aspects of conditionality and the sort of programs demanding the structural changes it deems fit to restoring to health of the aid recipient economy and ensuring simultaneously the safe return of its loan to the country. We find that the IMF conditions not only have pronounced free market ideological tilt, they are designed in oblivion to the socio-political environs of the recipient country and unduly intrude into its sovereignty. They tend, at times, to create more problems than they resolve

Finally, Sharia scholars invariably consider a writing on an economic topic incomplete unless its Islamic support or implications are not spelled out. deficit finance would not be an exception. To provide a religious angle to many post Islam modern developments like deficit financing falls in this category. The Qur'an refers in Sura Yusof to save out of the current surplus crop to fall back upon to meet the deficit forecast for the years ahead. Beyond this there is nothing in our view that can be related to current practice of deficit financing. We accept it until it is convincingly shown going against the Islamic law or custom in the same way as we have accepted not a few things in Islamic banking and insurance avoiding interest, indeterminacy and speculation. Foreign currency though money can be bought and sold as a different commodity presumably treating interest as a mark-up or rental.

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