Deficit financing in developing countries: Applications and consequences

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Abstract

Budgetary deficits and adverse external payments have emerged as major public policy concerns in recent times. The purpose of this paper is to discuss briefly various aspects and forms of deficit financing modern economies increasingly use to address these concerns.

Historical evidence shows that controlled deficit finance can be a useful tool to mobilize physical resources for economic development. Borrowings from the IMF are available to meet deficits during financial turmoil and chronic balance of payments deficits for country bailout. The paper warns of the dangers of reckless indulgence in deficit financing, internal or external - and indicates precautions to avoid the pitfalls. It puts presumably for the first time deficit finance for various purposes from different sources in a single framework.

Keywords - Deficit financing, Economic development; International Monetary Fund (IMF) conditionality; Arms race;

Introduction

The term 'deficit financing' has wide applications even extending to TV shows.[1] In economics, it connotes the amount by which a resource falls short of a given target; indicating most often a difference between cash inflows and outflows or the shortfall by which expenses or costs exceed income or revenues. In the context of developing countries the term refers to government budgetary deficits. To define:

"Deficit financing is a practice in which a government spends more money than it receives as revenue the difference being made up by borrowing or minting new funds".(Britannica.com).

Having a balanced budget - equating revenues and expenditures of a government -seems an ideal fiscal policy. However, even as socio-economic dynamism may not usually allow a perfect synchronization of the two variables, there are occasions when circumstances may force governments to run into a deficit. There are others, when they may find it

[1] Television deficit financing is the practice of a network or channel paying the studio that creates a show a license fee in exchange for the right to air the show. For more information see Wikipedia https://en.wikipedia.org/wiki/Television_deficit_financing

expedient to run a deficit. This has been true with reference to both developmental effort and crisis management.

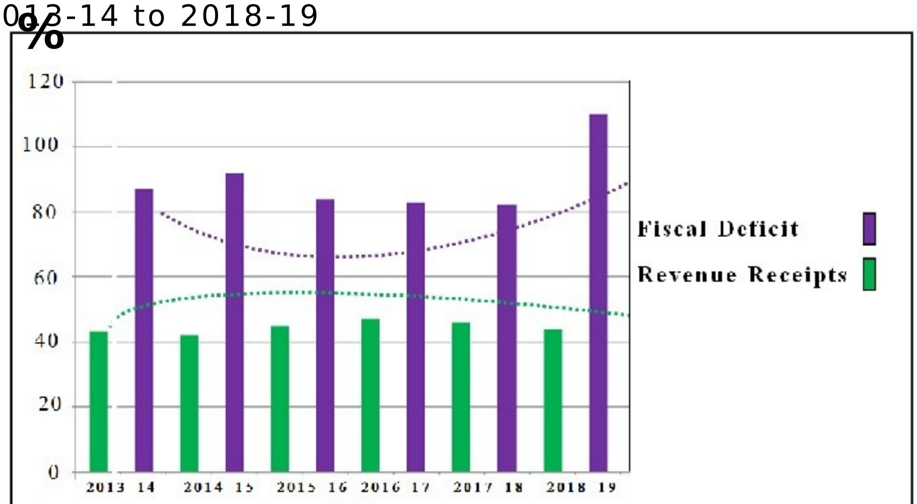
The concept of deficit is not as simple as it looks. Various indicators of deficit in the budget may be noted, as delineated by Jose (2016):

- Budget deficit = total expenditure – total receipts
- Revenue deficit = revenue expenditure – revenue receipts
- Fiscal deficit = total expenditure – total receipts except borrowings
- Primary deficit = Fiscal deficit - interest payments
- Effective revenue deficit = Revenue deficit – grants for the creation of capital assets
- Monetized fiscal deficit = that part of the fiscal deficit covered by borrowing from the central bank

Deficit may refer to any one or more of the above versions in a description Thus, specification is always better for clarity. Using the first concept of budget deficit may especially be deceptive. Take for instance the following case of Pakistan on budget deficit. Notice that in Figure 1 total revenues and expenditures are not much different; the budgetary deficit is small and fairly uniform. This is so because the details of income inflows and expenditure outflows are not available. Debt has swollen the receipts.

A better and more revealing definition of the gap is provided by the *fiscal deficit*—total expenditure minus total receipt *excluding borrowings*. Thus, fiscal deficit represents government's loaning from the market and is the best measure of the budgetary health of a country.

Figure 1: Fiscal deficit of India: percent change from 2013-14 to 2018-19



Auhor's construction

Data sources: Central Budget 2018-19

Figure 1 illustrates how political considerations, especially around elections, force deficit financing on governments. In the current Indian budget presented on February 1, 2019 the deficit rises despite a fall in estimated revenues for providing relief to the SMEs hit by demonetization and farmers agitating for loan waivers. Budgets tend to underplay deficits creating problems.

The main factors that cause fiscal deficit are the negative difference between revenue receipts and public expenditure in an accounting sense. The shortfall has an external component too — the excess of goods and services imported (M) over their exports (X) usually expressed as (X – M). A negative (X–M) enhances fiscal deficit and signifies the balance of payments problem. The government can bridge the fiscal gap from three sources:

- Mobilizing domestic savings through financial instruments like bonds or saving certificates. However, as the domestic savings pool is the same for different users and is limited, if government gets more, private enterprise will receive less. Aggregate mobilization and its impact on growth may be inconsequential.
- Printing of new currency notes 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.
- The third more commonly used source in the modern era is to borrow from abroad from friendly countries but mostly from international financial institutions, like the International Monetary Fund (IMF) as Pakistan is doing.

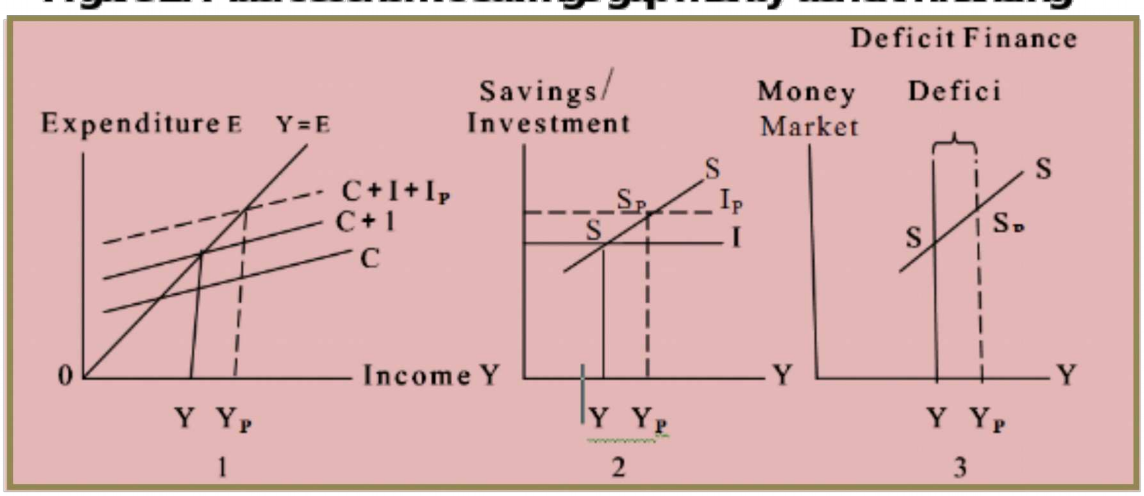
Rising corruption and governance inefficiencies tend to raise the cost of prestigious development projects over the years beyond the financial means of countries, pushing them to seek for, and even encourage, external capital inflows. Much of these flows is short-term and tends to fly away with the slightest signs of adversity—real or false—plunging the economy into crisis that snowballs. The economy eventually seeks finance from the IMF to cover the yawning payments deficit. Thus, a nexus is established between internal and international payments deficit.

This article is spread over four sections including the introduction. The following section explains how deficit financing is used as an instrument to mobilize physical resources for economic development, citing the experience of India's first two five-year plans. The discussion is then raised to the global level showing that countries falling into non-manageable deficits to meet their financial obligations seek funds from the IMF as members to look back in hours of need. Here, the term 'conditionality' that has to be met for obtaining the needed assistance is explained. The nature of programs falling under conditionality is discussed and evaluated in the light of the aid recipients' experiences. The discussion is then closed with a few concluding observations and suggestions.

Deficit financing and development experience

Interestingly, deficit finance can be used, and was for example used in India, as a tool to mobilize resources for development 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 showed a substantial shortfall from the requirements to meet the planned growth targets. This brought under consideration the possible use of a third source—deficit financing. The measure was the direct addition to gross national expenditure through budget deficits on the 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 Reserve Bank of India (RBI), the Central Bank of the country; thus *creating money* as Figure 2 demonstrates.[2] 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.

Figure 2: Macroeconomic savings gap met by deficit financing



To keep in check the inflationary potential of deficit financing (Section 3 of Figure 2), operations like taxation and saving schemes were launched for

[2] This explanation of deficit finance that the Planning Commission of India provided in paragraph 35 of the First Five Year document in 1951 is comprehensive, highlighting its nature possible sources, measurement and net outcome—that is money creation.

mopping up extra money generated. Price control and rationing of essential goods were put in place. The nature was merciful with monsoon rains for three consecutive years. Crops were good putting a tab on the prices of food grains and raw materials. The plan achieved its targets beyond expectations. The economy became stable and kicking.

The First Five Year Plan was designated largely to agriculture irrigation and pre-partition projects' consolidation; the second (1956-1961) aimed on industrialization and transportation, though agriculture got its due share. 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.

The two plans raised the GDP of the country at constant prices by 42% and per capita income by 18% despite rapid increases in population. 30 years were also added to the life expectancy of an average Indian. These were laudable achievements 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.[3]

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 additional money is not fully absorbed and must result in inflationary pressures via increase in effective demand. The situation aggravates if money adds to speculative activity. To ward off such possibilities effort is made to pull back the created money into savings through 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 alters the relative price structures to the disadvantage of weaker social groups; it perpetuates income and wealth

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

inequalities generating social unrest. 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 during 1950s. Things thereafter drastically changed for the worse on the price front during the Third Five Year Plan and beyond.

Crisis management

Micro units can and do indulge in deficit financing but it essentially is a macroeconomic phenomenon strictly falling in the fiscal policy domain. Keynes (1936) vigorously advocated using deficit financing as an anti-crisis measure when the 1930s Great Depression peaked, wage rigidity for downward adjustment becoming the obstacle in the way of remedial action.

In the 1930s crisis deficit finance was needed to revive the falling demand to cheer the gloomy markets; it was to create what Keynes termed as 'effective demand'. To this end, he advocated to employ people even to dig holes in the ground to put money in their pockets as wage and to employ them again to fill the same holes if needed. Thus, it was deficit financing mostly via printing money and was internal to governance. It was endogenous to the country's macroeconomic system.

This changed drastically during the great turmoil the subprime crisis of 2007 unleashed across countries for years. The locus for deficit finance shifted from revival of aggregate demand to the bailout of failing giant financial institutions, notably banks, insurance companies and funds. The need was *external* to the macroeconomic systems. The economy was no longer the recipient; it was the giver to the players of the financial markets to save them from a total annihilation of their own creation; of their greed and irrational exuberance. Institutions like insurance companies and funds—were running into huge deficits to meet their liabilities. This deficit was met by public funds.

A study by the Government Accountability Office (GAO) puts the 2008 financial crisis cost to the U.S. economy at more than US$22 trillion (Melendez 20113). It further observes 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 the financial crisis toll on economic output may be as much as US$13 trillion —an entire year's gross domestic product of the US economy. Furthermore, paper wealth lost by U.S. homeowners totaled US$9.1 billion while economic losses associated with increased mortgage foreclosures and higher unemployment since 2008 need to be considered as additional costs (Melendez, 2013).

How the crisis affected the Islamic financial institutions is a moot point even as an IMF survey (2010) lauds Islamic banks as being ‘More Resilient to Crisis’. Indeed, the literature is full of praises for Islamic finance on that count ascribing the achievement to two factors: Islamic finance maintains its links with 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. It has been 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 (Hasan, 2016). Thus, one must take the superiority claims with a grain of salt.

Deficit country bailout

So far we have discussed the use of deficit finance by a country between its government 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 IMF which has been established for helping member countries out of financial deficits, if they land in, by granting loans under a program governed by the terms contained in what is popularly known as *conditionality*. Earlier, it has been shown that the need for borrowing is linked to the rising costs of monumental projects and the ballooning funds the crisis management needs. Both costs are largely self-inflicted, natural calamities occasionally contributing.

Whatever be the reason, in essence the country is not able to escape default on its external commitments and liabilities unless helped to overcome the impasse. The last source for succor in such cases is the IMF. The help seekers are usually the developing countries while the funds the IMF provides to bridge the deficit come from the developed countries, the institution acting as their collective *mahajan*. IMF bailout loans are no charity; they are to be reimbursed in the common pool so that others in need could be helped.

The conditions IMF imposes are tight. So tight at times that they may 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 economic circumstance. The country is neck-deep in foreign debt substantially related to China Pakistan Economic Corridor (CPEC) involving US$60 billion of Chinese investment. Political economy seems clouding the matter (Rana, 2018). The IMF has asked Pakistan to be transparent in revealing the details of the Chinese (and other) debt before Pakistan’s application to bridge the deficit could be considered to which the country has agreed. Interestingly, China insists that the term of their debt to Pakistan must be fairly evaluated. Politics apart, 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 experience is a guide.

(i) The IMF Conditionality

When a country approaches the IMF for help, its government agrees to adjust its economic policies to overcome the problems that led it to seek financial assistance from the international community. The terms on which the IMF agrees to financially help a country in trouble are collectively called the IMF conditionality.

The IMF conditionality broadly consists of two parts: (i) the design of its support programs and (ii) the tools for monitoring the progress of program implementation. In principle, the programs are designed in consultation with the country seeking help. They essentially aim at resolving the balance of payment deficit problems of the country avoiding measures harmful to national or international prosperity. The monitoring measures at the same time oversee that the resources the IMF commits to help the country remain safe. The essence of conditionality is to help resolve the country's problems such that it is in a position to repay the IMF loan.

To reiterate, the member country seeking help has primary responsibility for selecting, designing, and implementing the policies that will make the IMF-supported program successful. The program is described in a letter of intent (which often has a memorandum of economic and financial policies) attached to it. The program's objectives and policies depend on the country's circumstances. 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.[4]

For ensuring progress in program implementation and to mitigate risk to the 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

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4 Apparently this looked fair but the borrowing country had to so frame the program as would ensure a safe return of the IMF loan.

for achieving the prescribed objectives. The review approvals are based on various policy commitments agreed with the country authorities.[5]

Program evaluation (ii)

A typical IMF program focuses on correcting the balance of payment problems of a country seeking a 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 each supportive of others.

Currencies of developing countries are mostly over-valued relative to the IMF based parities.[6] The depreciating currencies of help seeking countries bear testimony to this statement.[7] The assumptions supportive of devaluation are that the act would make domestic goods 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?

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 always have an exportable surplus ready at hand? Imports of these countries are even less price elastic. They import food grains to feed the teaming millions, 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. The private sector across the globe is showing itself no less corrupt, if not more; what caused the 2007 subprime debacle and what followed

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

6 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.

7 Note that the depreciation of a currency is not the same thing as its devaluation. Depreciation is a market phenomenon where a currency depreciates relative to some others. 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.

in its wake is evidence. Thus, the IMF bailout programs may not always or entirely prove conducive or helpful to the seekers.

In the year 1966, the currencies of 34 countries, mostly developing, went down on their knees under IMF programs. The Indian rupee was one of them; 35% being the devaluation. The University Grants Commission (UGC) the same year organized, probably under government instructions, a seminar at Meerut entitled ‘Foreign Aid in our Plans’. One of the specified topics was devaluation and foreign aid. The above arguments were then outlined by the author in his paper on the topic. Later developments vindicated the position taken. Food grains imports created payment problems as the Americans expressed their inability to export wheat to India and the USSR had to help the country out of the predicament with a wheat loan.

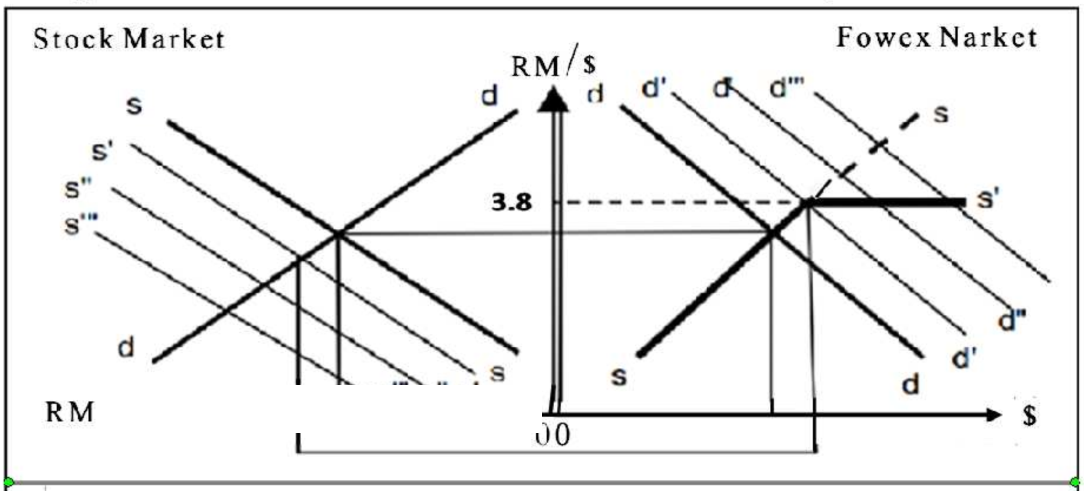
The episode also brought to the fore another danger of the devaluation-led bailout. Many developing countries start manufacturing products such as automobiles having a certain percentage of imported components. This percentage is gradually substituted with local makes until one looks back with satisfaction that a tiny fraction of the product is now imported. Many such industries find them at the sea, as India experienced, if that crucial fraction becomes unavailable due to the IMF program or its cost becomes prohibitive due to devaluation. Billions worth of plant investment stands still, rather hostage to foreign dictates.

More recent is the story of two countries dealing with financial crisis of 1997-98—both instructive and interesting. It was the massive short-term Western capital flight from South-East Asia that had then hit the flourishing economies of the region. Originating from Thailand, the contagion spread fast to other nations including Malaysia even as her economic fundamentals—contrary to the IMF assessment—were sound. Anyway, Thailand sought relief from the IMF while Malaysia eventually took a different route— it resorted to the imposition of exchange controls (Hasan, 2002).

In a small open economy like Malaysia, the flight of short-term capital during the 1997-98 crisis led 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 as Figure 3 demonstrates.

The run on the 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 raising the interest rates to arrest capital flight but it did not work. Eventually, Mahathir Muhammad, the astute Prime Minister of Malaysia who knew that there nothing was wrong with the country's economy, took the monumental decision to impose exchange controls rather than go to the IMF for bailout, despite internal dissensions.

Figure 3: Stock and Forex Markets interaction in Malaysia 1997-98



The exchange rate was stabilized at RM3.8 to US$1. The events unfolding in subsequent months vindicated the validity of his decision.[8]

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 (2001) declared: "The experience of Malaysia suggests that capital controls can help stabilize an otherwise difficult situation". The 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.[9] 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.

[8] The present author had then suggested a package of measures involving exchange control to remedy the situation in a seminar at the IIUM (June 1997) when the crisis was in the making. He later defended the action against criticism. See Hasan (2003).

[9] 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>/

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

The difficulty is that these conditions not only betray an ideological bias,[10] the insistence on structural adjustment and the macroeconomic interventions they require often make the situation worse for the recipient country, not better. This was the experience not only of Thailand but also of Indonesia and other aid receivers during the 1997 crisis. As a result of enforcing tight monetary regimes pursuant to the IMF conditions purportedly meant to reduce budget deficit and stabilize currency, problems aggravated. Contrary to their objectives the enforcement tended to slow down growth and spread unemployment in the aided countries. What happened on the exchange rate front? Even as the IMF aid programs' conditions have not understandably remained unchanged over time and space the departure in the case of Kenya concerning the rate of exchange during the 1990s is of interest. The IMF made the central bank of the country remove all restrictions to allow a fee flow of capital in or out of the country. The critics validly argue that the decision went against the country as it allowed the politicians to take their ill-gotten money out of the country.[11]

(iv) Demonstration effect and arms race

The vital question is: why do developing economies fall into external debt traps? Some reasons are obvious. There is a demonstration effect. Expanding means of transportation and communication, especially the internet resources and global advertising, have really converted the planet earth into a global village. The living standards and material affluence of the West coming into observation of people and leaders in developing economies awaken in them the urge to copy. In their eagerness to imitate, the society is more and more divided into haves and have-nots. A sizeable and expanding upper class is created 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 leaders and the affluent. Can this all be stopped so that money is spent where it is meant to

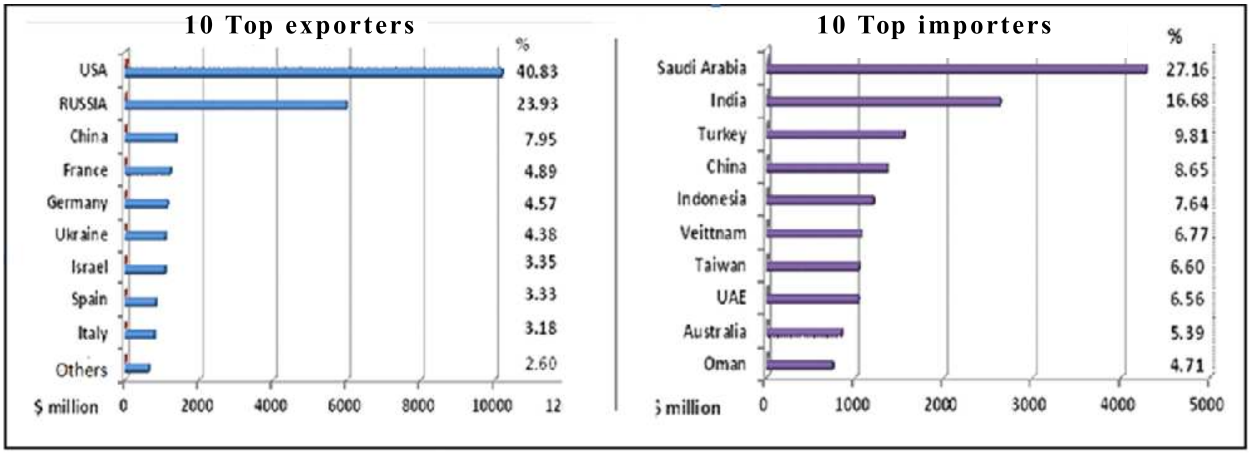
[10] The free market advocates criticize the IMF for the interventionist component in its relief program and demand that the institution should not interfere in the free play of demand and supply even in foreign exchange markets. Liberalization may especially be damaging in the least developed economies.

[11] For more case studies in an interesting evaluation of the IMF conditionality programs see the comprehensive research article of Kampamba (2012).

be spent? Imran Khan the new Prime Minister of Pakistan is trying to do it for building a Muslim country of his vision. Either he will soon give up or will achieve a miracle over time.

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 4: Leading exporters and imports 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 vis-à-vis 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 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 stretching the interpretation of an old authorization for the use of military force. Further, the US admits that costly wars are responsible for the current economic troubles of the US, not the trade with Beijing.[12]

Thus, so long as wars—hot or cold—continue to fuel the armament industry the distinction between developed and developing economies will continue. The

[12] Former French Prime Minister Dominique de Ville pin, speaking at the Global Leadership Forum organized 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

desire of the less privileged to "catch up with them" will continue creating deficits providing business to the IMF, the world money lender.

Concluding remarks

Pettifor Ann in a brilliant article (2019) projects her views on deficit financing in a Keynesian/monetarist framework. However her write up does not cover the various aspects of deficit financing relevant to *developing* economies characterized with the imperfections of markets, especially financial. Her theoretical prescriptions are not being applied or delivering even in the developed mature economies of the West, their relevance to emerging economies is all the more limited. In the present paper, we have argued that a full scale and focused discussion on deficit financing geared to developing economies must cover as discussed above the following three areas:

a) Use of deficit financing to mobilize physical resources to promote growth provided its inflationary potential could be kept under control.
b) Use of deficit financing to fight recession in the Keynesian vein where rigidity of wages to downward adjustment and fear psychosis of entrepreneurs is the inference.
c) IMF bailouts: The country is heavily indebted to outsiders, its balance of payments position is precarious and no internal solution is available as is presently the case of Pakistan. In such situations, the country seeks succor from outside, especially through the borrowings from the IMF and what it brings in its train.

In the first two cases the solution via deficit financing is internal to the domestic economic system; in the last it is external.

Islamic economists naturally want to look at modern developments from an Islamic perspective. Deficit financing is no exception. Thus, Ahmad (2019, 79) argues that from a religious viewpoint deficit financing must be avoided both in normal functioning of the government and during recessions. In either case, he advocates reliance on Zakah payments and taxation to meet current expenditure deficiencies and on sukuk –the Islamic bonds - to cover capital shortfalls He does not touch upon the adequacy or operability of either measure in relation to the current economic realities that obtain in most Muslin countries especially due to meager savings in Indonesia, Pakistan and Bangladesh; deficit could arise despite Zakah and *sukuk* may not fill the bill due to insufficiency of savings.

The Qurʾān in Surah Yusuf (12:43-48) calls for saving of the current surplus crop to fallback to meet the deficit as forecast for the years ahead. Beyond this there is nothing in our knowledge that can be related to current practice of deficit financing. There is a need to impart realism in the interpretation and application of the Shari'ah law (Hamaudi 2007). We accept its benefits and guard against ills of deficit financing 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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