Deficit Financing: Implications and Management

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Developing countries usually mobilize part of their resources by borrowing from internal as well as external sources to finance their development activities. These sources gradually build up the debt stock of the country. Such debt stock demands regular debt servicing, that is, principal and interest payment, which consumes scarce resources that can be used for financing development. Therefore, excessive deficits and heavy borrowing to finance that deficit drain out the resources of the developing countries. Liquidity is also involved while borrowing and servicing. Thus, both of these transactions are conducted in such a way that the country concerned always finds itself in a comfortable position with regard to the liquidity, which is known as the debt management.

I. INTRODUCTION

Government budget deficit is defined as the excess of spending over revenue. This is the phenomenon primarily of the post World War II period. Before the war the trend was of the balance budget. Then, the governments were not allowed to spend more than their means. The classical economists, namely, Adam Smith and others had warned the then governments not to incur budget deficit. During World War I countries involved in the war had no other choices than to go for budget deficits. Even during the war countries like England tried to mobilize additional revenues to defray war expenses than going for deficit financing. The introduction of the income tax system is the glaring example for this. In peacetime the governments seemed to have refrained from spending more than the revenue.

During the peacetime generally, the governments either payback the debt taken during the wartime or save for the future. This can be proved from the fact that the governments did not dare incurring the budget deficits when the private investments had sharply declined and the world economy had taken a sharp downturn during the period of the Great Depression of the 1930s. J.M. Keynes had to strongly advocate that during the period of economic crisis when the private investment is not forthcoming the governments must enhance investments even incurring budget deficits. He had said this to reactivate the world economy suffering from the protracted depression. Keynes' arguments had a great impact

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upon the governments in relation to their expenditure pattern. However, the impact in practice was seen only after World War II. Budget deficit seems historically to have arisen due to the increase in expenditure rather than the slowing down of the revenue mobilization.

Government budget deficits in industrial countries have been growing as a percent of gross domestic product (GDP) for the past 20 years. Large deficits emerged after the oil crisis in the mid-1970s and widened dramatically after 1980, largely the result of government overspending rather than the meager tax receipts. Government expenditures in industrial countries rose from 28 percent of GDP in 1960 to 50 percent in 1994. These deficits have sharply pushed up the public debt, which jumped to 70 percent of GDP in 1995 from 40 percent in 1980.

During the 19th and early 20th centuries, fiscal deficits and surpluses were small in the major industrial countries. World War I (1914-18) altered the picture radically, as its participants emptied their national treasuries and borrowed heavily against the future in a desperate struggle for survival. The interwar period saw a return to normalcy that brought huge deficits. World War II (1939-45) and the immediate postwar years repeated the fiscal experience of World War I and the interwar period—immense deficits in all countries followed by surprisingly satisfactory progress toward fiscal balance. Nevertheless, a disturbing trend began in the 1960s and gained seemingly irresistible momentum by the 1970s. Most economists agree that commitment to social welfare programs, demographic trends, and fundamental macroeconomic shifts are the main causes of the deterioration of the fiscal positions across the industrial world. The Great Depression elicited a reconsideration of the government's role in the economic life of the countries, forcing governments to social action. Still others suggest that the activism of the governments during World War II in providing health care, pensions, and other assistance to the members of the armed forces changed perceptions of the social responsibility of the government. Whatever the starting point, clearly a profound shift occurred in political philosophy between the start of World War I and the end of the World War II. In response, the governments, especially in Europe, established generous pension, national health care, family and child welfare programs, an extensive system of public education and long-term unemployment insurance.

These programs have sent government spending skyrocketing. By the mid-1960s, spending was up in all industrial countries. In Canada, France, Italy, and Japan, it climbed by 8-11 percentage points during 1975-93, while in the United States, Social Security and Medicare rose to 22 percent of general expenditures in 1992. As a percent of total spending, U.S. public welfare spending nearly tripled during the period.

The oil embargo of 1973 caused havoc on an unprepared and oil-dependent industrial world. What is well remembered, however, is that those price hikes occurred during a period of steadily rising prices, which contrasted with the long-term price stability prevalent in the industrial world.

Budgetary issues in developing countries differ from those in industrial countries. Usually, developing countries have other goals from those of industrial countries, focusing, for example, to a greater degree on building infrastructure, creating an industrial base, and encouraging new businesses. Their population are younger and less skilled, and they have limited access to capital. Fiscal policy in developing countries faces unique challenges. Budgets are smaller, personal incomes are lower, and tax collection is often erratic. Much employment opportunities are created outside the formal economy, making transactions difficult to tax. Financial markets in developing countries are often inefficient, making it hard for governments to finance their deficits. With lower government revenues, most developing countries have lower public expenditure than industrial countries. Developing countries in Asia and the western hemisphere have been spending the least and those in Africa, the Middle East, and the Eastern Europe spend the most. Yet, the majority of developing countries run deficits, with the occasional exception of the middle-income countries.

Fortunately for their fiscal prospects, the developing countries do not spend as much on social welfare programs (pensions, health care, and unemployment insurance) as industrial countries do. Younger population put less spending pressure on governments, and in many countries there is joint family system and elderly members are taken care of by their own families.

Large and persistent fiscal deficits push up interest rates, reduce investment, and create a burden of indebtedness that is difficult for the governments and taxpayers to bear. Deficits also interfere with the effective functioning of markets at home and abroad. Most important, they compromise the living standards of current and future generations.

II. NEPAL'S BUDGETARY DEFICITS

Nepal, being a least developed country, has been incurring fiscal deficits from its very beginning. In the first budget of the country, i.e. of 2008 B.S. revenue was estimated at Rs.30.5 million and total expenditure at Rs. 52.5 million incurring thus the fiscal deficit of Rs.22.0 million. This trend has continued uninterruptedly until now. The level of deficit, however, has varied from year to year. Table 1 illustrates the trend of Nepal's deficits for the last one and half decade.

Table 1 shows that Nepal's fiscal deficit can be said to be neither too high nor too low in comparison to other countries standing at the similar level of development. It is seen that since FY 1993/94 the fiscal deficits has stood at a rather low level and this is mainly due to entering into Enhanced Structural Adjustment Facility or the ESAF with the International Monetary Fund or the IMF. Following this agreement, Nepal introduced the economic liberalization program under which determination of bank interest rate, exchange rate of Nepalese currency vis-à-vis other convertible currencies and price control were deregulated and this function was given to the market. Such liberal policy required the macroeconomic stability. And fiscal deficits had to be kept at as low level as

TABLE 1. Budgetary Deficits of Nepal (Rs. in Million)

Fiscal Year	Total Expenditure	Total Revenue	Foreign Grants	Deficits		After Grants Deficits as % of GDP
				Before Grants	After Grants	
1987/88	14,105.0	7,350.4	2,076.8	-6,754.6	-4,677.8	6.4
1988/89	18,005.0	7,776.9	1,680.6	-10,228.1	-8,547.5	10.0
1989/90	19,669.3	9,287.5	1,975.4	-10,381.8	-8,406.4	8.4
1990/91	23,549.8	10,729.9	2,164.8	-12,819.9	-10,655.1	9.2
1991/92	26,418.2	13,512.7	1,643.8	-12,905.5	-11,261.7	7.8
1992/93	30,897.7	15,148.4	3,793.3	-15,749.3	-11,956.0	7.2
1993/94	33,597.4	19,580.8	2,393.6	-14,016.6	-11,623.0	6.1
1994/95	39,060.0	24,575.2	3,937.1	-14,484.8	-10,547.7	5.0
1995/96	46,542.4	27,893.1	4,825.1	-18,649.3	-13,824.2	5.8
1996/97	50,723.7	30,373.5	5,988.3	-20,350.2	-14,361.9	5.3
1997/98	56,118.3	32,937.9	5,402.6	-23,180.4	-17,777.8	6.1
1998/99	59,579.0	37,251.0	4,336.6	-22,328.0	-17,991.4	5.5
1999/00	66,272.5	42,893.8	5,711.7	-23,378.7	-17,667.0	4.8
2000/01	79,835.1	48,893.6	6,753.4	-30,941.5	-24,188.1	6.2
2001/02	80,072.2	50,445.5	6,686.1	-29,626.7	-22,940.6	5.7
2002/03	84,006.1	56,229.8	11,339.1	-27,776.3	-16,437.1	3.8

Source: Ministry of Finance (2004, 2004a).

possible to maintain such macroeconomic stability. Moreover, the IMF had included the maintenance of fiscal deficit at the stipulated level into the list of performance criteria. Therefore, since then Nepal has been conscious enough about the negative impact of large fiscal deficits upon the economy and the country has been trying to maintain low fiscal deficits even after the expiry of the ESAF. Nepal has sometimes sacrificed even growth to maintain macroeconomic stability by slashing down development expenditures especially in the years when revenue mobilization fell short of the target. And this has contributed also in maintaining stability in inflation, exchange rate, interest rate and balance of payment. This has also helped in maintaining a relatively low level of debt burden upon the country.

III. IMPACT OF FISCAL DEFICIT ON GROWTH AND STABILITY

The conclusion about the impact of fiscal deficit on growth and stability is that higher the level of fiscal deficits higher may be the growth rate but there will also be higher probability of macroeconomic instability. Because the higher level of fiscal deficit means the higher level of money supply and since money supply has a direct positive relationship with the price, higher fiscal deficits may push up the price level unleashing thus the forces of macroeconomic instability. As higher price level reduces the export competitiveness resulting thus in the decline in exports and increase in imports, this ultimately results in the adverse balance of payment and depletion of the international reserves of the country. And this exerts pressure on the strength of the domestic currency or domestic currency is depreciated. This also lowers the level of interest rate since the higher level of money supply pushes up the level of liquidity in the economy. Thus, the higher level of fiscal deficit results in the macroeconomic instability.

However, the liberal economic policy has different arguments in this regard. It says that if the government finances higher level of fiscal deficit through internal borrowings, private sector is crowded out in terms of using domestic resources and, therefore, private sector investments is squeezed resulting thus in the lower growth rate. This implies that higher level of fiscal deficits does not always ensure higher growth rate. Another argument along the similar line is that private sector investment does not come forward in the condition of macroeconomic instability. Thus, economic growth does not take place in the instable macroeconomic situation resulting from the large fiscal deficits. From this standpoint also, large fiscal deficit does not necessarily result in the higher growth rate. Therefore, under the liberal economic policy under which private sector is considered as the engine of growth, maintenance of macroeconomic stability is much emphasized. And for this, the government must incur as less fiscal deficit as possible to maintain macroeconomic stability in the country. This is what the IMF, World Bank, Asian Development Bank and others have been emphasizing over these years. Nepal also has been pursuing the similar policy since the beginning of the 1990s.

This, however, does not mean that the governments should not spend more. They can spend more as much revenue as they can mobilize. This only implies that they should spend as per their means and they must not spend beyond their means.

Another growth hampering impact of the large fiscal deficit is that higher the fiscal deficit higher will be the debt burden of the country. And higher the level of debt burden, higher will be the level of debt servicing expenditure of the government and higher the level of debt servicing expenditure lower will be the government's investment for growth. Ultimately growth will be hindered if the government spends substantially higher than its means.

IV. DEBT MANAGEMENT

Internal

Public debt management may be defined as those official policies, which alter the size and composition (i.e., maturity and holders) of government debt. It is a peculiar area of public finance in that it bridges the gap between taxation and public expenditure and strict monetary policy (the control of the supply of money and changes in the rate of interest). The public debt raises finance for government expenditure, as do taxes, but in so doing it influences the rate of interest and liquidity in the economy.

Public debt can be defined in various other ways. The most comprehensive definition would encompass all claims against the government bonds, treasury bills, saving certificates, post office savings accounts, the deposit obligation of the central bank (the balance held by the central bank on behalf of other financial institutions) and finally all currency—which is the most liquid (instant) claim on the government. This broad definition of the national debt focuses our attention on a most important characteristic of debt –its liquidity. The national debt can cover the whole spectrum of liquidity; it can be wholly liquid (e.g., currency) or it can be almost totally illiquid (e.g., irredeemable bonds).

Debt management can therefore be thought of as the control of this liquidity. Depending on the size of the national debt held domestically, it can be at the same time one of the most potent influences on the economy and one of the most opaque or difficult to understand.

A narrower definition of the national debt would include only government bonds and small savings. This, of course, can still cover the spectrum of liquidity from a day (a bond about to be redeemed) to the irredeemable, but it omits currency. It is this narrower definition which national debt statistics usually refer to, though it is worth keeping in mind the larger emphasis on liquidity.

The objectives of the debt management are as follows:

- To influence the size and maturity of debt;
- To influence the appropriate pattern of interest rates;
- To affect the type of holder of the debt;
- To achieve short-term stabilization of bond prices;
- To limit debt service cost;
- To create capital market;
- To give priority to domestic over foreign issues on domestic market, and,
- To give priority to public sector borrowing.

The following instruments are used to achieve the above-mentioned objectives of the debt management:

- Open market operation;
- Timing of issues;
- Coordination among authorities and banks on issues;
- Bonds innovations tailored for issues;
- The privileges;
- Queuing;
- Pressure to favor government bonds, and,
- Restrictions on foreign access to the market.

In Nepal, the domestic debt management is mainly being carried out with the objectives of maintaining appropriate interest rates, affecting certain type of holder of the debt and short-term stabilization of bond prices. The size is not currently being considered. The maturity of debt is sometimes taken care of. And to achieve these objectives, the first three instruments are being used. Open market operations of government treasury bills are being effectively conducted in the Nepal Rastra Bank. The Debt Management Committee represented also by the Ministry of Finance considers also the timing and the size of the bills to be transacted.

External

Developing countries like Nepal use external borrowing as a mechanism to address the gap between the government revenue and its investment and the export-import gap. Such borrowing adds to the total resources available to the government over a given period and enables the government to make higher expenditure than would otherwise be possible. If properly utilized such resources can benefit the borrowing countries and contribute to its economic growth and poverty reduction. However, when inefficiently allocated, the cost of borrowed external resources can contribute to macroeconomic management problems in the form of high or even unsustainable levels of external debt-servicing obligations. The use of borrowed external resources should contribute not only to increased supply of goods to meet the domestic needs, but generate—by increasing the country's capacity to export—adequate real resources to service the liabilities incurred. External debt management is, thus, an integral part of macroeconomic management involving the planned acquisition, deployment, servicing and retirement of external loans to foster economic growth, poverty reduction and sustainable development without creating external payment difficulties.

Therefore, external debt management involves coordinating several major aspects of economic decision making that have a bearing on loan contracting, utilization and the debt servicing needs and capabilities. Very often, there is a lack of coordination and cooperation among these principal agencies that results in inappropriate levels and terms of borrowings or incomplete records of a country's debt stock, and difficulties in meeting debt service obligations in a regular and timely manner. Such uncoordinated borrowing not only complicates the debt management, and in particular debt monitoring, but is also a source of wider problems for macroeconomic management.

V. ESSENTIAL ELEMENTS OF EFFECTIVE EXTERNAL DEBT MANAGEMENT

The key elements of an effective external debt management are as follows:

- Policy guidelines on the appropriate level, terms and purpose for foreign borrowing;
- Reorganization of the existing stock of external debt so as to maintain an optimum debt structure;
- Monitoring the operations relating to loan commitments, disbursements (loan utilization) and debt servicing on all borrowings preferably on a loan-by-loan basis;
- Accurately recording and maintaining detailed loan-by-loan information;
- Preparing projections of debt and debt service levels to facilitate domestic cost budgeting and foreign exchange management;
- Liaison with various creditors, keeping them informed of macroeconomic developments;
- Regular portfolio reviews on a sector and/or creditor basis. In a portfolio review it should be possible to cancel projects, which are not performing well, and stop new loan disbursement so as to contain future debt service costs.

While the external loans increase resources available in the disbursement period, it has long term repercussions associated with the call on future productive resources to service it. The growth of external debt should, therefore, be planned. The level of new external borrowing and the terms on which it may be contracted should be clearly established. A forward-looking analysis of the country's external debt-servicing capacity should be an integral component of the external debt management process. This involves analysis of the existing stock of external debt and the streams of future debt service obligation in relation to the country's economic performance taking into account its GDP growth, export growth, import requirement and the level of reserves.

Such analysis and records should allow the calculation of the most common debt indicators: the debt service ratio, the present value of debt outstanding to exports of goods and services, external debt to GDP ratio, the reserves to import ratio (reserve coverage), and reserve to short-term debt ratio. The least developed countries like Nepal should have goals to reduce non-concessional loans to a minimum, obtain the most concessional terms possible and maximize grant receipts from the donors. The database should also have the existing debt stock with respect to the currency composition, maturity profile and the interest rate structure. External debt management may also include debt rescheduling, if necessary, in which payment of principal and/or interest due during a specified period are restructured with a new repayment schedule and terms.

For the effective external debt management, a comprehensive inventory of all the loan agreements with detailed information on each loan needs to be compiled and centrally maintained. The basic loan details required are generally available from the original loan agreements. Such information include:

- The type of instrument, creditor institution or country;
- The debtor, that is, whether the funds are for the central or local government or state enterprise and whether it is guaranteed by the central government or not;
- The amount committed and currency of the loan, commitment fees, rate of interest, grace period and number of installments per year;
- The agreement date, the date from which commitment fees accrue, date of effectiveness, events of default and the terminal date for disbursements;
- The purpose for which funds have been borrowed and prior conditions for the loan to be effective or drawn down;
- Amount and currency of disbursement, and undisbursed balance;
- The method of disbursement, that is, whether it is by direct payment to suppliers on a reimbursement basis, or by other means such as advances; and
- A disbursement schedule.

External debt management is necessary for the indebted countries for avoiding the debt servicing obligation difficulties. This also helps the borrowing countries to effectively utilize the external resources. Therefore, in recent years, the IMF, World Bank and the Asian Development Bank have been providing financial as well as technical assistance for establishing the scientific system of the external debt management in the developing countries.

VI. DEBT STOCK OF NEPAL

Nepal has also been receiving external loans from the beginning to bridge the resource gap. However, being a least developed country, Nepal has been receiving concessional external loans from the International Development Agency or IDA of the World Bank, which is established to provide the concessional loans to the least developed countries. The loans from that institution are for the period of up to 40 years and with a grace period of up to 10 years. And the interest rate (service charge) also is less than 1 percent. The loans taken from that institution by Nepal constitutes around 75 percent of the total external loan stock of the country. Therefore, it is not likely to face debt-servicing difficulties in the near future.

Table 2 presents the total debt outstanding of Nepal up to the FY 2003/04, which shows that Nepal's total outstanding debt has reached a little more than two-third of the national income of the country. In view of the level of the development and the per capita income of the country, this level of outstanding public debt should be taken as burdensome. However, due to the high proportion of the concessional loans, the debt servicing is rather low relative to the debt stock.

TABLE 2. Nepal's Total Debt Stock (Rs. in Million)

Fiscal Year	External	Internal	Total Debt	GDP	Total Debt as % of GDP
1987/88	20,826.0	11,636.0	32,462.0	73,170.0	44.4
1988/89	29,216.9	12,887.9	42,104.8	85,831.0	49.1
1989/90	36,800.9	14,673.1	51,474.0	99,702.0	51.6
1990/91	59,505.3	20,855.9	80,361.2	116,127.0	69.2
1991/92	70,923.6	23,234.9	94,158.5	144,933.0	65.0
1992/93	87,420.8	25,456.1	112,876.9	165,350.0	68.3
1993/94	101,966.8	30,631.2	132,598.0	191,596.0	69.2
1994/95	113,000.9	32,057.8	145,058.7	209,974.0	69.1
1995/96	128,044.4	34,241.9	162,286.3	239,388.0	67.8
1996/97	132,086.8	35,890.9	167,977.7	269,570.0	62.3
1997/98	161,208.0	38,406.7	199,614.7	289,798.0	68.9
1998/99	169,465.9	49,669.6	219,135.5	330,018.0	66.4
1999/00	190,691.2	54,357.0	245,048.2	366,251.0	66.9
2000/01	200,404.4	60,043.7	261,594.3	393,563.0	66.5
2001/02	220,125.6	73,620.7	293,746.3	405,632.0	72.4
2002/03	223,433.2	84,645.3	308,078.5	435,531.0	70.7
2003/04	245,211.4	83,020.9	328,232.3	472,424.0	69.5

Source: Ministry of Finance (2004).

Table 3 presents the debt servicing position of Nepal. Due to the concessional nature of external loans, interest payment on this loan is low compared to the principal and in case of internal loan interest payment is far greater than the principal one. External debt service ratio is around 7 percent according to the IMF's calculation.

TABLE 3. Nepal's Debt Servicing (Rs. in Million)

Fiscal Year	Principal		Total	Interest		Total	Total Debt Servicing
	External	Internal		External	Internal		
1987/88	297.5	100.0	397.5	293.5	750.6	1,044.1	1,441.6
1988/89	388.6	145.5	534.1	312.7	873.9	1,186.6	1,720.7
1989/90	701.8	100.5	802.3	421.8	1,055.1	1,476.9	2,279.2
1990/91	589.0	150.0	739.0	497.5	1,170.9	1,668.4	2,407.4
1991/92	942.2	264.8	1,207.0	722.7	1,867.4	2,590.1	3,797.1
1992/93	1,252.9	345.0	1,597.9	879.0	2,083.6	2,962.6	4,560.5
1993/94	1,468.2	430.0	1,898.2	1,020.5	1,936.4	2,956.9	4,855.1
1994/95	1,828.2	825.0	2,653.2	1,156.5	2,273.6	3,430.1	6,083.3
1995/96	1,987.7	859.8	2,847.5	1,316.6	2,551.3	3,867.9	6,715.4
1996/97	2,102.4	1,350.9	3,453.3	1,247.0	2,826.9	4,073.9	7,527.2
1997/98	2,780.2	1,151.0	3,931.2	1,421.0	2,330.6	3,751.6	7,682.8
1998/99	3,196.5	1,446.2	4,642.7	1,549.0	2,531.3	4,080.3	8,723.0
1999/00	3,681.0	1,531.6	5,212.7	1,640.3	3,179.8	4,820.1	10,032.8
2000/01	4,500.6	1,190.0	5,690.6	1,700.8	2,997.0	4,697.8	10,388.4
2001/02	4,751.4	1,683.6	6,435.0	1,816.1	3,954.1	5,770.2	12,205.2
2002/03	5,497.5	4,062.0	9,559.5	2,021.7	4,610.1	6,631.8	16,191.3

Source: Ministry of Finance (2004).

VII. EXTERNAL DEBT MANAGEMENT IN NEPAL

Nepal does not so far have any system of external debt management worth the name. Several times, the country has taken external technical as well as financial assistance for developing the system of external debt management. And every time external consultants have developed the system for the purpose. However, the system does not proceed forward as the external consultants leave the country. The situation is such that concerned authorities and Nepal do not keep track even on when, how much, to which creditor and in which currency the principal and interest on external loan is to be repaid. They actually know the repayment schedule only when the creditors remind them in advance. Therefore, every year the gap between the budgeted amount and the actual amount of repayment remains very wide. Such absence of system has created no problems so far. But if it happens, the country will have to pay a heavy price. Hence, it is suggested that urgent attention should be given to develop and operate a scientific system of external debt management.

VIII. CONCLUSION

Although Nepal's debt burden and its servicing should not be called as excessive, on the basis of its level of development, it is quite burdensome. In other words, debt burden has reached this level even to achieve such meager development. Nepal has not taken high growth path so far and once it takes it will require enormous amount of investment and that investment will have to be made through borrowing from both domestic as well as the external sources. At that time Nepal will have to borrow an unlimited amount of financial resources from both the sources. In other words, the time of heavy borrowing is coming to Nepal a little later. Therefore, until our growth rate takes momentum, we should be extremely judicious while borrowing to finance the budget deficits. Another worrying issue in this regard is that we have not, so far, developed and introduced debt management system in Nepal. Now it should not be delayed even a single minute to introduce this system to remain safe from paying heavy price sooner or later.

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