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Mystery of twin deficits

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Standard macroeconomic theory suggests a strong causal relation between fiscal deficit and current account deficit. Higher fiscal deficit leads to higher current account deficit. In other words, large fiscal deficit is accompanied by a large current account deficit. In economics literature, this is known as the twin deficit hypothesis.

How does it work? In simple words, when a government spends more than the revenue it collects, it borrows from domestic and foreign sources to fill this revenue - expenditure gap? Such borrowed spending injects additional money into the economy. Domestic residents use some of the additional money to boost their consumption, part of it will be spent on foreign goods and services, thereby raising import demand. Additional money so injected into the economy will boost aggregate demand which will be translated into higher imports. Higher imports will worsen trade balance and accordingly will deteriorate current account balance.

When countries fail to manage their fiscal balance, they see their current account balance deteriorating. To finance their large current account deficits, they either borrow externally or use their foreign currency reserves or a combination of both. Accordingly, they accumulate large external debt and see their foreign currency reserves declining and exchange rate coming under pressure. These countries face serious balance of payments crises.

When these countries go to the IMF (lender of the last resort) for a balance of payment support, the IMF advises them to pursue stabilization policy. What is stabilization policy? It is nothing but a demand management policy or a demand destruction policy or austerity policy. What are the instruments of stabilization policy? Tight fiscal policy, tight monetary policy along with flexible exchange rate policy are the critical policy instruments to destroy aggregate demand. Once demand is curtailed, it will help reduce import demand. Flexible exchange rate policy will help promote exports, curb imports and accordingly, the trade and current account balance will improve. This was the whole purpose of stabilization policy.

Pakistan has gone to the IMF several times in the past for balance of payments support and was forced to pursue demand destruction policy each time. In fact, Pakistan has been one of the nine prolonged users of the IMF resources. More recently, Pakistan completed an IMF Programme during 2013-2016 under the leadership of Ishaq Dar, the then finance minister of the country. It has been claimed, both by the Pakistani and the IMF authorities, that this program was a "successful" program as it succeeded in reducing budget deficit from 8.5 percent of GDP in 2012-13 to 4.6 percent of GDP by 2015-16, that is, Pakistan's fiscal deficit was reduced to the extent of almost 4.0 percentage point of GDP during the program period.

Anyone who reads this statement would be impressed by the 'success' of the IMF Program in reducing budget deficit and hence, keeping current account deficit at manageable level (less than 2 percent of GDP) and that the IMF Program 'succeeded' in restoring macroeconomic stability in Pakistan. In my last article "A $67 billion question", published in this newspaper (August 8, 2018), I showed through government statistics that it was not the IMF program which kept current account deficit low but it was the sharp and unprecedented decline in international price of oil that reduced the oil import bill and accordingly kept overall imports under control that helped in keeping current account deficit low. IMF Program should, therefore, not take any credit for reducing the twin deficits.

This article is a continuation of my previous article. In this article, I would once again show that the IMF Program failed to reduce budget deficit and accordingly failed to reduce import demand, failed to reduce current account deficit and hence failed to restore macroeconomic stability.

My claim is that Pakistan failed to reduce budget deficit under the IMF Program during 2013/14 to 2015/16. Budget deficit on the basis of consistent definition as existed in 2012-13 has never been below 8 percent of GDP. The government showed lower budget deficit through accounting gimmickry and by changing definition of revenue, expenditure and budget deficit.

Few examples would be sufficient to make my point. Firstly, circular debt has been part of the expenditure item since 2010-11 (See SBP Annual Report 2013-14). The previous regime cleared outstanding circular debt by paying Rs. 329 billion on June 5, 2013 which caused budget deficit to reach as high as 8.5 percent of GDP in 2012-13 (the last year of the PPP regime). The previous regime took circular debt out of the budget since 2013-14 onward to show lower deficit. Thus, the budget deficit number for the year 2013-14 onward is not at all comparable with 2012-13. My advice to the new finance minister would be to ask the concerned staff of the Ministry of Finance to prepare a fiscal table consistent with 2012-13. This will truly reveal as to where do we stand in terms of fiscal deficit.

Secondly, foreign grants have always been treated as financing item and have appeared as below the line item. But the previous government treated foreign grant (Saudi Money) as non-tax revenue to inflate overall revenue and as such reported a lower budget deficit.

Thirdly, the blatant use of "Statistical discrepancy" to show lower expenditure and hence lower budget deficit is yet another example. I can list another half a dozen examples but the above three examples are more than sufficient to make my point that budget deficit has never been below 8.0 percent of GDP during the IMF programme.

Since budget deficit has never been below 8 percent of GDP during the last five years, the higher deficit kept fueling aggregate demand that translated into higher import growth and worsening of current account deficit. These facts are well-documented in Tables 1 and 2. A cursory look at Table 2 is sufficient to see that the overall import growth presents a distorted picture. As a result of massive decline in International price of oil in July 2014 onward, the oil import bill continued to decline sharply and hence overall import growth turned negative during 2014-15 and 2015-16.

Adjusting for oil import, the non-energy import growth exhibits an accelerating trend, growing by 8.2 percent and 13.0 percent in 2014-15 and 2015-16, respectively (during the IMF Program). The critics may suggest that this rising growth in non-energy import also include CPEC-related machinery import. To answer such critics I calculated non-energy non-machinery import growth which are documented in Table 2. It can be seen from Table 2, that non-energy non-machinery growth also accelerated during the IMF Program. It grew by 6.8 percent in 2014-15 and 10.3 percent in 2015-16. Such a rising trend in import growth sans oil import clearly reflects rising aggregate demand which, in turn, was the result of the persistence of large fiscal deficit.

The bottom line is that the last IMF Program (2013-16) failed miserably in reducing the budget deficit. Higher budget deficit continued to fuel aggregate demand that translated into higher imports and exacerbated the current account deficit.

A few other economists and I, had continued to educate the people of Pakistan that the IMF Programme was not a Programme in the traditional sense, it was simply a vehicle to lend money at a relatively cheaper rate to the then government. (Read "An Open Letter to the IMF", published in this newspaper on October 24, 2016).

While the people of Pakistan should be grateful to the IMF for preventing economic destabilization by doling out billions of dollars to the previous regime, they, at the same time; should be held responsible for damaging of key economic statistics as well as wasting 3-5 years' time of Pakistan because of their neglect in ensuring economic reforms. In every Review report, the IMF would simply write that the reform program was "broadly on track", while in actuality no meaningful reforms were undertaken.

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Table 1: Trends In Imports and its Component (Billion $)

Year	Total Imports	Non-Energy Imports	Machinery Imports	Non-Energy Non-Machinery Import
2012-13	40.2	26.1	4.0	22.1
2013-14	41.7	26.9	5.0	21.9
2014-15	41.4	29.1	5.7	23.4
2015-16	41.3	32.9	7.1	25.8
2016-17	48.7	38.1	7.4	30.7
2017-18	55.8	42.5	8.7	33.8

Table 2: Trends In Imports

(Growth Rates %)

Year	Total Imports	Non-Energy Imports	Machinery Imports	Non-Energy Non-Machinery Import
2012-13	-	-	-	-
2013-14	3.7	3.1	25.0	-0.9
2014-15	-0.7	8.2	14.0	6.8
2015-16	-0.2	13.0	24.6	10.3
2016-17	17.9	15.8	4.2	19.0
2017-18	14.6	11.5	17.6	10.1