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***Ṣukūk*: A Sharīʿah Compliant Tool for Financing Budget Deficits**

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ABSTRACT. The lead paper (Pettifor, 2019) discusses an important issue at the macroeconomic level, especially the impact of financing government's expansionary budget deficit through borrowing. The paper reiterates that claiming that the use of loans to finance the deficit will lead to a decline in the economic activity and will in turn increase the deficit, is a common misconception. In fact, the data on the British economy over a period of a hundred years, as shown in the lead paper, proves that there is a positive relationship between the volume of the budget deficit (and public debt) and economic activity. This, in turn, lead to a decrease in unemployment and thus, eventually contributed to a reduction in the budget deficit. These results have been proven by other researches as well as I have mentioned in this paper. I have also pointed to other researches which indicate that there is a negative relationship between the size of the debt (or the budget deficit), and economic activity, which contradicts the hypothesis of the lead paper. In this brief comment on the lead paper, I also discuss the fact that the global debt phenomenon has become a burning issue. I present a summary of the state of international debt around the world and discuss its impact on the economies of many countries that repay their debts in hard currencies. I argue that this situation must be taken into consideration when discussing the impact of borrowing to finance the government budget deficit to stimulate economic growth. I also propose that these effects on the borrowing economies should also be analyzed in the event that these international loans are in the form of Islamic instruments (*ṣukūk*) which are increasingly being used by some governments as a tool to finance their budget deficits, especially among the OIC countries. However, because it is a modern financing tool, several years need to pass before we can viably test the relationship between them and economic growth and the extent of their impact on key variables at the macro level of the economy.

***Keywords*:** *Ṣukūk*, Macroeconomics policy, Foreign borrowing, Budget deficit.

***JEL Classification*:** E62, H62, H63

***KAUJIE Classification*:** R48, R73, R81, R82

1. Introduction

Ann Pettifor's lead paper (2019) is a very interesting one. The paper discusses the effects of public debt and government expenditure on economic growth. Citing some research articles and analysis, it identifies a fundamental error in contemporary economic discussions. She states:

> [T]he empirical evidence discussed in this paper indicates that expansionary fiscal policy financed by loan issues will lead to growth in economic activity and employment. In an economy with spare capacity and idle resources, high government expenditure generates income, including tax revenues and thereby reduces the government deficit, and cuts public debt. (Pettifor, 2019, p. 67)

In a recent article, Stella Spilioti (2015, p. 174) mentions that the relationship between public debt and GDP growth has been examined extensively in economic literature. She mentions (p. 174) that the general conclusion, supported by empirical studies on advanced and emerging economies, is that in the long-run public debt has a negative impact on economic growth (see for example, Diamond, 1965; Saint-Paul, 1992; Schclarek, 2005; Adam & Bevan, 2005; Aizenman, Kletzer, & Pinto, 2007).

Spilioti mentions that, in the Euro area, gross government debt and deficit ratios have increased rapidly in the aftermath of the 2007-2011 financial crisis. This has a negative impact on the long-term fiscal sustainability. She raises an important question stating: "Within this economic and financial background, an important question that arises is whether the negative relationship between high levels of public debt and economic growth, is observed only above a certain level of government debt" (Spilioti, 2015, p. 174). She cites (p. 174) a number of empirical studies which show that external debt and economic growth are negatively correlated with each other and that this correlation becomes particularly strong when debt reaches a certain threshold (see, for example, Pattillo, Poirson, & Ricci, 2002; Reinhart & Rogoff, 2010; Kumar & Woo, 2010; Cordella, Ricci, & Ruiz-Arranz, 2010; Cecchetti, Mohanty, & Zampolli, 2011, Checherita-Westphal, & Rother, 2012).

Spilioti investigated the relationship between government debt and GDP growth in 14 countries of the Euro area using data from the period 1981-2014. She uses a growth equation which also includes other control variables such as: (a) variables capturing the impact of inflation, (b) indicators of the openness of the economy and the external competitiveness, and (c) other control variables related to the demographic characteristics of the economy as well as indicators that are expected to influence future investments. The empirical results of her study suggest that public debt and GDP growth are positively correlated with each other and that the relationship is statistically highly significant (Spilioti, 2015, p. 174).

Thus, the result reached by Ann Pettifor and Stella Spilioti is the same, despite the fact that the second is covering many countries excluding UK which is covered by Ann Pettifor.

2. Global State of the Islamic Finance Sector

Being an Islamic economics researcher, I would like to add value to the discussion from the Islamic economics viewpoint especially how Islamic financial instruments can help in financing budget deficits. Thus, it may be a good start to have a very brief idea about the global state of the Islamic finance sector.

The Global Islamic Economy Report 2017/18 by Thomson Reuters mentions the latest developments and trends while also highlighting the future direction of this sector. It mentions that the global Islamic economy "is at the cusp of major growth and widespread recognition, having gained traction as Muslims assert their religiosity and traditional values" (Thomson Reuters, 2017, p. 4).

The report mentions that multinational companies are investing heavily in Muslim-majority markets in anticipation of the rising demand. Private equity investment and sovereign wealth funds have also been particularly active.

The report estimates that the Islamic finance sector has about $2.2 trillion in total assets while the sector continues to evolve. Recognizing the segment's potential, commercial banks are ever increasingly converting to fully-fledged Islamic institutions. This is true not only in Muslim-majority countries, but in Muslim-minority countries as well. Governments are also encouraging Islamic finance to improve financial inclusion. *Ṣukūk* are one of the fastest growing Islamic financial instruments. The report mentions that during the previous year there were a number of debut *ṣukūk* issuances while many more in the pipeline (Thomson Reuters, 2017, p. 4).

3. Foreign Loans, Budget Deficits and the Role of *Ṣukūk*

In such an environment, more governments are stepping into the market of *ṣukūk* to finance their budget deficit. Nowadays, *ṣukūks* are playing an important role as a financing tool in the government's budget deficit financing policies. As *ṣukūk* is a relatively new financing tool, it is too early to conduct empirical studies to examine the impact of such tools and we need to wait for a good number of years to pass before enough data is available. It should be noted that *ṣukūks* are not straight loans like bonds, rather they are financing tools which are asset backed or asset based (for details, see: Zolfaghari, 2017).

Moreover, there is a need to investigate the impact of foreign loans, as many countries tend to borrow from the international market in hard currencies. The foreign loan in *ṣukūk* form became very normal in many OIC member countries as a source of budget deficit finance. Taking into account the effects of such financing tools on the foreign exchange and the balance of trade of a country and the problems that they entail, more care needs to be taken to fully examine the long-run impact of such tools on GDP growth. The following facts from World Bank statistics prove the importance of the need to examine the impact of foreign loans on GDP growth especially for those developing countries who use hard currencies to pay back loans or *ṣukūk*.

Statistics published by the World Bank mentioned that:

1. Net financial flows (debt and equity) to low and middle-income countries rose 61 percent in 2017 to the highest level in three years, driven by a rebound in net debt inflows.
2. Net financial flows climbed to \$1.1 trillion in 2017, a level last seen in 2014.
3. Net debt inflows (loan disbursements minus principal repayments) spurred the increase, more than tripling to \$607 billion from \$181 billion in 2016 and surpassing net equity flows for the first time since 2013.
4. Contributing to this rise was a \$297 billion inflow of short-term debt in 2017 after a combined outflow of \$532 billion in 2015 and 2016.
5. Long-term debt inflows increased by 58 percent in 2017 to \$309 billion as a result of a rise in bond issuance.
6. The jump in long-term debt inflows in 2017 was fueled by widespread new bond issuance by both public and private sector entities in low- and middle-income countries and purchases of domestically issued sovereign bonds by non-residents.
7. New bond issuance in 2017 reached a record high of \$355 billion pushing net inflows (new issuance minus redemptions i.e. principal payments) to \$262 billion, or 85 percent of net long-term debt inflows, almost twice the comparable share in 2016.
8. The remaining 15 percent of inflows were from official bilateral and multilateral creditors.
9. While external debt burdens on average remained moderate and were little changed from 2016, one third of low- and middle-income countries had a ratio of external debt-to-GNI above 60 percent at end 2017 and nearly half the countries had debt-to-export ratios exceeding 150 percent.
10. External debt stocks on average rose 10 percent in 2017, but increases were much larger for some countries. On average, external debt burdens remained moderate and were little changed from 2016. The ratio of debt-to-GNI and to export earnings for low- and middle-income countries averaged 25 percent and 102 percent, respectively in 2017, but for some countries, those ratios were substantially higher. (The World Bank, 2018, p. 3; numbering and paras added)

The main focus of Ann Pettifor's study was to show the result of empirical evidence from 100 years of UK statistics to prove that expansionary fiscal policy financed by loan issues will lead to growth in economic activity and employment. However, her analysis fails to take into account all kinds of governments' borrowing as mentioned in World Bank statistics. The figures quoted above clearly show that governments tend to borrow continuously from abroad to finance extra expenses over taxes received (deficit) by them. This trend is affecting the global status of economic development and the long-term impact of this global trend should be looked at to show the future economic changes that might face all countries in debt.

A recent study about *ṣukūk* issuance to finance budget deficits in Indonesia identifies potential retail state *ṣukūk* as part of state bonds that are used to replace foreign debt and lower the government's budget deficit. Unfortunately, the government's budget deficit continues to rise each year in many countries as shown in World Bank statistics due to the increase of foreign debt. In many countries, the increase in the debt itself is closely related to exchange rate fluctuations. In such cases, which are too many around the world, it is important for a government to develop a relatively secure funding mechanism. The government of Indonesia has developed state securities based on Sharīʿah (SBSN) which can be used not only to reduce finance deficit but also to alternatively finance the infrastructure development (Amaliah & Aspiranti, 2017, p. 21).

This may prove that OIC countries, due to their Muslim population, believe in moving towards using *ṣukūk* mechanisms to raise funds locally or internationally to finance their budget deficits. However, some years must pass before it is feasible to test the impact of such mechanisms on the short-term development variables, especially, employment, inflation, and the balance of trade.

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الصكوك: أداة متوافقة مع الشريعة لتمويل العجز في الميزانية

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المستخلص. تناقش الورقة الرئيسية (بيتيفور، 2019م) قضية مهمة على مستوى الاقتصاد الكلي وخاصة تأثير تمويل العجز الحكومي للنشاط التوسعي في المالية العامة باستخدام القروض. وتؤكد الورقة خطأ الزعم أن استخدام القروض لتمويل العجز سوف يؤدى إلى انخفاض النشاط الاقتصادي وزيادة العجز، بل إن الاحصائيات للاقتصاد البريطاني على مدى مائة عام، كما أشارت إليه الورقة، أثبتت العلاقة الإيجابية بين حجم القروض وبين النشاط الاقتصادي الذي زاد بزيادة القروض وأدت كذلك إلى خفض البطالة وساهم في تخفيض عجز الميزانية. وهذه النتائج قد أثبتتها بحوث أخرى أشرت إليها، كما أشرت إلى بحوث أخرى أثبتت العلاقة السلبية بين حجم الديون وبين النشاط الاقتصادي وعجز الميزانية وهو ما يخالف فرضية الورقة. وأناقش في تعليقي على الورقة أن ظاهرة الديون العالمية أصبحت مثيرة للاهتمام وذكرت خلاصة حالة الدين الدولي في العالم وتزايده وتأثيره على اقتصاديات العديد من الدول التي تسدد مديونياتها بالعملات الصعبة، وأن هذا الوضع يجب أن يؤخذ في الاعتبار عند مناقشة تأثير الاقتراض لتمويل العجز في الميزانية الحكومية على النمو الاقتصادي، وأنه يمكن أيضا تحليل هذا التأثير في حالة أن تكون هذه القروض الدولية في شكل الصكوك الإسلامية التي بدأت تغطى حيزا متناميا كأداة لتمويل العجز في ميزانيات بعض الحكومات في دول منظمة التعاون الإسلامي، لكن لكونها ممارسة حديثة فإن هناك حاجة لمرور عدة سنوات يمكن بعدها اختبار العلاقة بينها وبين النمو الاقتصادي ومدى تأثيرها على المتغيرات الرئيسية على المستوى الكلي للاقتصاد.

الكلمات الدَّالة: صكوك، سياسة الاقتصاد الكلي، الدين الخارجي، عجز الميزانية.

تصنيف JEL: E62, H62, H63

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