Year of the `Big Squeeze'? Malaysia in 2013

*The second session of the ISIS Praxis Seminar 2013 discussed Malaysia's budget deficit and the 2013 budget. The panelists were **Mr Nurhisham Hussein** of the Malaysian Rating Corporation Bhd (MARC), Mr **Azrul Azwar Ahmad Tajudin** of Bank Islam Malaysia Bhd, and **Mr Gerald Ambrose** of Aberdeen Asset Management Sdn Bhd**.** **Tan Sri Datuk Dr Kamal Mat Salih**, a Distinguished Fellow of ISIS Malaysia moderated the session. ISIS Research Associate, **Justin Lim** reports.*

From left: Nurhisham Hussein, Kamal Mat Salih, Azrul Azwar Ahmad Tajudin and Gerald Ambrose

Malaysia has been struggling to reduce its budget deficits for over a decade now, due to higher growth in public spending than growth in revenue. Public sector spending has in fact been on an increasing trend since 2009. The federal government is expected to reduce public spending progressively by embarking on broadening its tax base through the Goods and Services Tax and rationalising subsidies.

As such, can public spending be reduced by 2013 and can the private sector take over, thereby preventing a severe economic contraction? Would the on-going global economy continue to weigh on Malaysia's growth performance? What is the limit of government's policy in handling another crisis?

Mr Nurhisham Hussein gave his perspectives on Malaysian fiscal deficits and debt. He described the main driver of Malaysia's growth as being external trade, on which the nation is still heavily dependent and which amounts to more than 100% of GDP**.** Also, compared to previous years, this year's growth was heavily dependent on public and private sector investments. He stressed that current fiscal policies such as the self-imposed 55 per cent debt ceiling, desire for faster fiscal consolidation, continuing dependence on oil revenue and the narrow tax base may inhibit future growth.

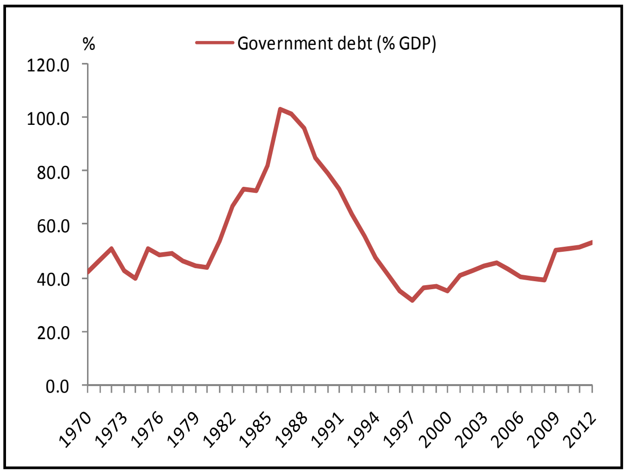
Does this mean there is no space to manoeuvre? Nurhisham says there is, as focusing on fiscal policies alone is not enough; the policies should be evaluated in tandem with monetary policies. Policy-making is not just a binary choice of fiscal or monetary policy, but a continuum between the two.

Moreover, there is no ideal policy mix, as the situation is largely dependent on the prevailing economic climate. The aspiration of faster fiscal consolidation can be achieved through corresponding looser monetary policy, achieved in turn by either increasing money supply or lowering interest rates. But such measures will result in higher leveraging by the household and corporate sectors, and will in fact substitute government debt which would otherwise be further increased if there were no fiscal constraints. The aggregate debt of the economy still grows, irrespective of who contributes to it.

Before pursuing such expansionary policies, due consideration must be given to the prospect of looser monetary policy ultimately pushing up asset prices and consumer inflation too.

Having said that, Nurhisham said that the current debt level, which is fast approaching the 55 per cent debt ceiling, and its corresponding threat to the stability of the economy is exaggerated. (See Fig. 1)

Fig. 1 Malaysia: Government Debt



Current debt levels are actually near their historical long term average and the debt servicing ratio is at an all time low too. Furthermore debt is mainly financed domestically, with nearly 95 per cent denominated in Malaysian ringgit and this makes the economy less exposed to foreign exchange rate fluctuations and external shocks. The double digit current account surpluses that were registered consistently each year for the last decade are also more than sufficient to offset the growing fiscal debt.

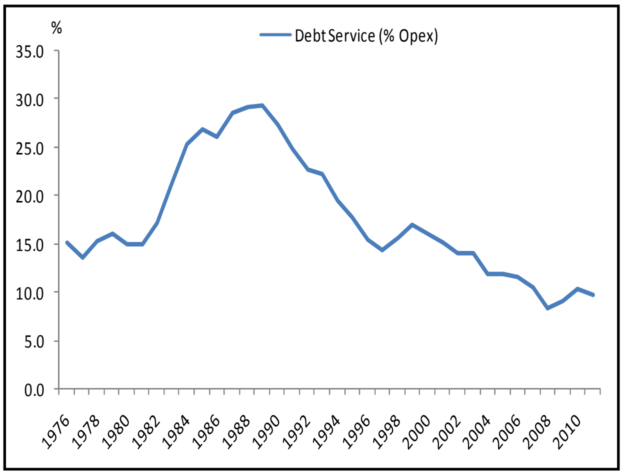
Nurhisham Hussein

The only other cause for concern is the foreign holding of Malaysian government debt, which has increased steadily since the year 2008. Thus the government is more exposed to external events which can affect the repayment ability of its debtors.

On the savings side, the private sector has been saving more during the 15 years since the Asian financial crisis and now accounts for 90 per cent of total national savings. But household savings consist of approximately two per cent only; government savings make up the remainder. Nurhisham considers this bad news as a high corporate savings rate translates to a shortfall in total national consumption and investment. Both the private sector and government have to increase spending to make up for this trend.

In concluding his presentation, he said that this trend and its subsequent effects are more worrying than the current debt level and the debt servicing ratio, and must be addressed. (See Fig. 2) This was later reinforced by the other panelists who felt that in addition to fiscal consolidation, there needs to be a further liberalization of the private sector, especially in sectors which have strong government intervention, to incentivise corporations to invest again and drive the economy forward.

Fig. 2 Malaysia: Debt Service



The second panelist, **Mr Azrul Azwar Ahmad Tajudin,** took a contrary stand to Nurhisham's and stressed that the ballooning deficit is in fact a serious concern. In arguing this, he said that it is the inherent overdependence on oil and gas revenue and the large operating expenditure incurred that makes the deficit dangerous. Also, the deficit does not take into account existing government contingent liabilities and guarantees which are estimated to be at least RM117 billion, and if these are taken into consideration, the debt-to-GDP ratio will amount to a whopping 66 per cent.

He finds the deficit reduction target of four per cent by 2013 ambitious because of the lack of fiscal reforms, and coherence in fiscal strategies. The aggressive tax collection initiative that boosted revenues in 2011 and 2012 may have reached a plateau and its maximum efficiency by this year. Also 2013 is the year the elections are scheduled to be held, and contractionary policies will not be popular among the electorate.

Azrul then outlined concrete steps that should be taken to reduce the deficit. Measures to boost revenues by diversifying the revenue base include: introducing the Goods and Service Tax (GST), a special tax on millionaires that is higher than the current top taxation rate of 26 per cent, higher 'sin' taxes, capital gains tax on the sales of non-inventory assets such as shares and securities, and rechanneling incentives and tax breaks to higher-value added industries.

Operating expenditure must be rationalized and capped. Right-sizing emoluments and government pensions are his main thrusts and these include: temporary freezing of non-executive recruitment, not replacing outgoing civil servants, and retraining and redeploying excess staff to new job functions.

Secondly, the procurement process needs to be reviewed such that leakages and overpayments can be reduced by promoting the use of the open tender process and imposing stringent cost controls.

Thirdly, the subsidy rationalisation programmes under Pemandu should be continued and lastly non-productive capital expenditure and expenses should be eliminated.

He concluded his presentation by stating that fiscal consolidation targets are more realistic in the near-to-medium term outlook, and subsequently, we should aim for a balanced budget by the year 2020.

Azrul Azwar Ahmad Tajudin

There were comments from the floor that freezing the hiring of civil servants would not be possible given recent initiatives by the Public Service Commission (PSC) to hire non-Malay staff. The government's role in absorbing a burgeoning youth population which would otherwise not have jobs in the private sector should not be overlooked too.

It was agreed that despite the large workforce, at least a third of the 1.2 million civil servants are made up of teachers, the police and the armed forces, all of which are usually excluded in other countries and a direct comparison will overstate the size of Malaysia's civil service. As such, continued hiring for these key sectors is crucial but that does not eliminate the fact that certain sectors are overstaffed and these staff need to be redeployed.

However, a panelist criticised this emphasis on the public sector's role of job creation for a growing youth population. He argues that this is actually a disincentive to economic growth because the private sector is much more efficient at job creation. Also, private sector employment usually leads to higher wages and productivity as compared to public sector employment.

He said the government's role should be to promote a healthy and competitive private sector environment with less government intervention, which he said was more important than the creation of lower value-added jobs by the public sector.

Mr Gerald Ambrose provided an overview of the debt levels of countries from around the world. While debt levels of developed countries have increased, those of developing countries have decreased since the 2008 financial crisis.

His main thrust was poor investments by the private sector; investments have dropped and remained low since the 1998 Asian financial crisis. Conversely, growth has been increasingly export-led and this trend is expected to continue, as can be seen by the high correlation factor of 0.96 between growth and real exports as a percentage of GDP since the year 2001.

Gerald Ambrose

Ambrose then described government revenue, categorised between commodity-linked and non-commodity-linked sources. His analysis showed that government revenue is highly commodity-linked and this is not good due to the highly volatile nature of the prices of commodities.

Also, operating expenditure which has ballooned and overtaken development expenditure in the last ten years does not bode well for Malaysia. Development expenditure can be compared to planting seeds for future yields, i.e. revenue; it should be given the highest priority.

In conclusion, the panelists agreed that although debt levels are alarming, structural problems that can significantly aggravate the economy or lead to a Western-type financial and economic crisis are not foreseen. However more should be done. Besides the suggestions raised earlier, we need more efficient spending, further liberalization of the private sector, better quality education and higher female participation in the workforce.