Expanding Amidst Contraction? Malaysian Economic Policies and Performance in 2011-2012

*The third session of the Inaugural ISIS Praxis Seminar 2011 discussed Malaysia's economic performance and its policies in 2011-2012. The panelists were **Dr Albert Zeufack** of Khazanah Nasional, **Mr. Nor Zahidi Alias** of Malaysian Rating Corporation Berhad (MARC) and **Dato' Dr Mahani Zainal Abidin** of the Institute of Strategic and International Studies (ISIS) Malaysia. **Dr Rozali Mohamed Ali** was the moderator of the session. ISIS Researcher **Nor Izzatina** reports.*

From left: Mahani Zainal Abidin, Albert Zeufack, Rozali Mohamed Ali and Nor Zahidi Alias

The Malaysian economy recovered from the recent global financial and economic crisis and in 2010 generated positive economic growth of 7.2 per cent, from 2009. This put Malaysia back into the growth trajectory of Vision 2020. However the three panelists warned about factors that might derail the attainment of Vision 2020; several policies are expected to be implemented by the government to ensure growth is robust in 2011-2012 and beyond.

The downside to Malaysia's economic prospects can be traced to external economic conditions after the 2008-2009 crisis. As of the beginning of 2011, countries around the world can be divided into two categories; a) countries that are still dealing with the repercussions through ongoing de-leveraging and debt consolidation processes and b) countries that experienced record growth in 2010 due to the low growth base of 2009, but are still having difficulties in sustaining high growth momentum.

The prospect for the Malaysian economy falls into the second category. **Dr Albert Zeufack** made this argument stronger by using indicators such as; i) real growth fixed investment ii) employment growth in advanced economies iii) real private consumption for both emerging and advanced countries and iv) ISM index for manufacturing sectors in the United States, China and other main Asian countries. All this points to the probability that the recovery recorded in 2010 may falter within the next two years.

Mr Nor Zahidi Alias provided an explanation for the future projection of the Malaysian economy when he pointed out that the expected slower growth in 2011 will be due to weaker external trade (smaller net exports) due in turn to waning global demand for electrical and electronic (E&E) products. This trend was illustrated by the projection of global chip sales in 2011 and 2012. The economy is expected to grow moderately by 6.0 per cent and 3.4 per cent respectively in the two years.

Current geo-political events in the Middle East added a further dent to fragile global economic growth. Since the people's uprising spread across the Middle East, commodity prices, especially that of crude oil, have been on the rise. The three panelists agreed that shocks in commodity prices will influence the global recovery process.

Given the gloomy global economic outlook, what can Malaysia do?

Countries can still push towards high economic growth despite discouraging external conditions but not without economic costs. One option is through borrowing from the future. Given this option, there is the possibility that 2008-2017 will be known as the 'decade of debt' said Dr Zeufack. He also added that this will prolong the process of private leveraging, open new ways for future banking methods, and provide solutions to the sovereign debt crisis. Malaysia like other nations also has the option of increasing its future commitments to fund its immediate aspirations.

With an uncertain global outlook, Malaysian policymakers are more than ever forced to be introspective. In order to maintain growth trajectory of six per cent (GDP growth) for the next nine years, policymakers must be able to stimulate domestic growth through investment and consumption. Supportive monetary and fiscal policies are needed if such a direction is to be pursued.

Accommodating interest rates will set the tone for private investment in Malaysia and its ability to grow. However, according to Nor Zahidi, interest rates in Malaysia are low enough for capacity buildup, exhibited in rising Malaysian consumers and producers price indices (CPI and PPI), and the increase in payroll and employment in the manufacturing sectors. Normally the overnight policy rate (OPR) reacts to rising capacity utilization to prevent the second-round effect or a higher increase price level from occurring. This signifies that the OPR cannot be kept at its current level, and readjustment is needed.

The intention to adjust the OPR to reflect the current economic situation is an invitation for a further influx of capital from around the world, added Nor Zahidi. Massive capital inflows are evidenced by the surge in the local stock and bond markets and are in the form of portfolio investments. However entry of hot money from abroad is highly related to swings, and any drastic outflow can affect both the financial market and the real economy.

To show how open the Malaysian economy is to the world, **Dr Mahani Zainal Abidin** pointed out that capital inflows into Malaysia's domestic capital market is an outcome of the Quantitative Easing 2 (QE2) undertaken by the Federal Reserve. The increasing capital inflows also exert upward pressure on the ringgit which will in turn impact Malaysia's trade performance. With Malaysia's real effective exchange rate currently hovering above its mean, any sudden reversal in flows will affect the ringgit's performance, which will hurt Malaysia's balance of payments.

Another reliable instrument used to prop up economic growth is fiscal policy. Malaysia has been using fiscal policy to expand public investment. One such policy is the subsidy of retail fuel prices. However given the short period between the global financial crisis and the current slow growth outlook, the Malaysian government

Participants at the conference

cannot be expected to take another expansionary role. Expanding on Dr Zeufack's points, Dr Mahani agreed that government action to finance the growth initiative through debt financing can cause a huge stress on the future of economic performance.

However, the use of fiscal expansion as a policy option is still on the table, although its form might be different. Dr Mahani added that it is expected that the next General Elections will be announced well before the end of 2013 and that this will act as a stimulus for the economy. It is certain that elections in the state of Sarawak this year will require fiscal spending.

While revenues collected by the government are steady and growing, considering the relatively high tax-to-GDP ratio and the recent commodities rally, the burden on the government subsidy programme is expected to grow. Nor Zahidi pointed that the crux of Malaysian government finance lies in its operating expenditures, where the subsidies are, and not in development expenditures. The exuberance of the first half of 2010 made the government, with PEMANDU's assistance, embark on a subsidy rationalization exercise that will see subsidies being reduced and eventually removed.

However the current rally of oil and food prices have added pressure to maintaining domestic retail prices for some goods, despite efforts to phase them out. If the government decides to refrain from taking future debt and rapidly eliminates subsidies, there will be a negative impact on household consumption.

In relation to fuel subsidies, Nor Zahidi established a positive correlation between high petrol retail prices, the retail trade index and the consumer sentiment index. With the additional volatility in international food prices and huge food deficits in Malaysia's trade, household incomes will be pressured to undergo changes, and ultimately, consumption will be scaled back, shaving Malaysia's growth prospects even further.

Dr Mahani added that sustaining household confidence is crucial, given the uncertain world economy. While it might be possible to create higher consumption growth through higher consumption requirements and easy credit, a weak domestic outlook with rising fuel retail prices, the commodities and food prices rally, the property market asset bubble and existing high household debt have all proven that the household sector is not the best sector for growth.

Malaysia's private investments suffered after the 1998 Asian Financial crisis. To counter this, strategies like the Economic Transformation Programme (ETP) and Government Transformation Plan (GTP) were introduced in 2010, to improve Malaysia's appeal as a business and investment destination. Since the introduction of the ETP in October 2010, the private sector has pledged RM67 billion. On the other hand, reforms under the GTP, such as improving government effectiveness in managing issues like street crime, and public transportation, are qualitative in nature.

Despite these efforts, a stronger momentum on ETP implementation is required as RM65 billion worth of investments are needed every six months until 2020 in order to reach Malaysia's private investment target of RM 1,311 billion, which is a prerequisite to reach the high-income threshold bracket under the Vision 2020.

With excess capacity reported under the manufacturing sector, private investments in the service sectors are imperative to make Malaysia's economic growth sustainable.

While domestic-driven economic growth will be pursued, Dr Mahani re-affirmed the role of external factors in Malaysia's economic growth. She pointed out that trade policy through bilateral and regional arrangements will continue to be pursued as an avenue for Malaysia's goods and services. Productive capital outflows, in the form of M&A and FDI, to high impact sectors, must be encouraged for the purpose of technology transfers and strategic industries. Trade in finance can be intensified in niche services like Islamic banking and finance.

The 2011-2012 economic outlook may on the surface look grey. However, with effective policy designs, Malaysia's economy can avoid the malaise that dents economic growth. The government must not rely completely on normal economic tools such as fiscal expansion and interest rate reduction to propel growth. Measures such as increasing reserve requirement ratios and private-public partnerships (PPPs), as exhibited in the Iskandar Johor project, are among policy options that can be used.