THE NEED TO STEP UP FISCAL STIMULUS

Understandably, all eyes are on the forthcoming budget to be unveiled on 1 September. The government has been pursuing a pragmatic fiscal policy in recent years, with deficit budgets to stimulate the economy, in the aftermath of the 1997/98 financial crisis. What makes this fiscal policy all the more palatable is that the deficits have not only been kept within manageable limits but also been downsized gradually with a view to eventually balancing the books.

To be sure, Malaysia has never been averse to using the fiscal instrument to influence the economy even if not in a strictly counter-cyclical manner. Fiscal deficits work well to stimulate demand in situations of excess supply as in economic downturns. Likewise fiscal surpluses help reduce excess demand in times of economic overheating. However, fiscal stimulus will not work if the problem is structural in nature, which calls for reforms. If the problem were on the supply side, fiscal stimulus would only lead to what economists call “fiscal fatigue”. This was indeed the case for Malaysia in the early eighties when huge budget deficits became unsustainable. Japan too has learned the hard way in the nineties that deficit budgets are no substitute for structural reforms.

As mentioned, Malaysia had run burdensome fiscal deficits in the early eighties, with deficits as a percentage of gross domestic product (GDP) soaring to double-digit levels, which flew in the face of fiscal discipline. It is hard to believe that Malaysia’s budget deficit accounted for 15.6 per cent and 16.7 per cent of GDP in 1981 and 1982, respectively, sowing the seeds of the 1985 recession. It certainly was a bitter lesson in fiscal management that no country can afford to forget. The budget deficits were gradually reduced from 1987 onward before being reversed, after 1992, into budget surpluses for the next five consecutive years until 1998.

Without a doubt, it is good economics to run budget surpluses in boom years and budget deficits in lean years. Malaysia has been registering budget deficits since 1998 when the economy suffered its worst recession in history. The fiscal deficits were necessary to take up the slack in private sector spending so that the economy could be lifted from the doldrums, with increased public expenditures providing the much-needed shot in the arm for the ailing economy.

However, Malaysia’s persistent budget deficits even after the economy had recovered have raised eyebrows internationally, which has led the Malaysian authorities to devise a strategy to gradually downsize the deficits and set a medium-term goal to balance the books. It is pertinent to note that Malaysia has the highest deficit/GDP ratio among all crisis-hit countries. Korea was the first to register budget surplus immediately after the 1997/98 crisis. In Southeast Asia, Singapore has been posting budget surpluses (6-8 per cent of GDP) since 2003. Thailand, the epicentre of the crisis, currently runs balanced budgets after garnering small budget surpluses in 2003 and 2004. Like Malaysia, Indonesia has been incurring deficit budgets year after year since the outbreak of the

Asian financial crisis, but Indonesia's deficits as a proportion of GDP pale in comparison with that of Malaysia's.

Malaysia's key macroeconomic indicators all look picture-perfect except for the fiscal deficit. The latter has contributed to the low sovereign rating Malaysia gets internationally. It is concerns such as these that have led the Malaysian authorities to work towards balanced budgets through gradual reductions in budget deficits. The ratio of Malaysia's budget deficit to GDP has fallen from 5.8 per cent in 2000 to 3.8 per cent last year. The fiscal target for this year is to trim the imbalance down to 3.5 per cent of GDP. Going by this trend, if one were to extrapolate, the deficit/GDP ratio is likely to be downsized further in the upcoming budget for next year. A re-think, however, is in order.

All indications are that the Malaysian economy is decelerating, primarily due to weaker external demand. The United States, the main export destination for Malaysian manufactures, is experiencing economic slowdown under the weight of ballooning twin (budget and current account) deficits, soaring oil prices and rising interest rates. Euro-zone economies too are weak with sluggish growth and mounting unemployment. Japan is the only notable exception among the OECD countries this time around, but increased economic activity in Japan has not translated into increased import demand. Malaysian Institute of Economic Research (MIER) has downgraded Malaysia's GDP growth to 5.2 per cent for this year and 4.8 per cent for next year, which fall below the Ninth Malaysia Plan target of 6.0 per cent per year on average.

The Malaysian economy is now in need of a stronger fiscal push. A compelling argument in favour of an expansionary budget for 2007 is that the economy is clearly under-performing, way below its potential, estimated at 6.5 per cent. Increased public expenditures would stimulate domestic demand and take the economy closer to the potential growth trajectory. Fiscal authorities need not fret about the bigger fiscal imbalance so long as it remains within manageable proportions. It is pertinent to point out that the country's fiscal deficits are largely financed by domestic borrowings. There is no need to resort to external borrowing to finance budget deficits, as there are amble domestic savings. What is more, the federal government debt stands at only 43 per cent of GDP, while its external debt stays below 40 per cent of GDP, which are quite low by international norms.

Besides, there is no universally applicable threshold for fiscal prudence. What is good for one situation may not be good for another. The European Union has adopted a rule-of-thumb deficit/GDP ratio of 3 per cent for its member countries (although France and Germany have exceeded the EU limit in recent times). For Malaysia, this is hardly the time to get any closer to a balanced budget. The situation warrants a more assertive fiscal policy with increased budget deficit of around 4 per cent of GDP, a step back perhaps in the country's medium-term fiscal agenda. At times, it is good to take a step back before moving forward.

Arguably, Malaysia's budget deficits are only illusionary, as it does not take into account the savings of many off-budget agencies such as Petronas. The latter's surpluses after

paying taxes and royalties are substantial, given the high prices of oil. Had Petronas been an on-budget affair, Malaysia's budget deficits would likely have turned into surpluses of sorts, although this smacks of wishful thinking. The point nonetheless is that there is no real basis for undue worries over budget deficits under the current circumstances. Put in a nutshell, it is time to up the fiscal ante.

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