Consumption Spending Unlikely to Lift the Economy

As 2005 draws to a close, the government, amidst the current slowdown, is still a notch more optimistic, expecting the economic outlook for the year ahead to be a little better. Underpinning the optimism is the forces of recovery in the global electronic cycle that are now slowly falling into place. The US factory activity, as indicated by the surge in the new orders for electronics products tracked by the Institute of Supply Management (ISM), a useful 6-month leading indicator for Asia's exports, has raced ahead to 16.8 per cent in August from 13.3 per cent in July. And this will start to lift an IT export-dependent economy like Malaysia by year-end or by the first quarter of next year.

However, the government expects the recovery in external demand to be somewhat muted, growing only a tad stronger by 9.3 per cent against the estimated 7.7 per cent in 2005. Like in 2005, the economy in 2006 will be without another important key driver - the stimulus from fiscal spending. Six years of expansionary fiscal policy has left a gaping hole in the government's financial position that requires stitching up. Without a positive impulse from fiscal spending and a significant boost from external demand, consumption spending, which accounts for almost close to 50 per cent of real output, is again officially expected to come to the rescue of the economy.

Despite giving up some ground recently, the government expects consumer spending to grow by a still robust 7 per cent (7.5 per cent in 2005), providing a big support to an estimated real output growth of 5.5 per cent. But, given the above scenario, could real consumption spending be strong enough to really come to the rescue of the economy in 2006? We think there is little reason to believe that the stage is set for private consumption to remain that resilient.

First, household is already highly geared with a debt (consumption credit and purchase of residential property) to GDP ratio of 56.6 per cent. While we are not yet nearing a bubble (using South Korea's yardstick of in excess of 70 per cent), pre-emptive measures, especially on credit card spending and the issuance of new cards, need to be taken to avert a credit bubble. Such measures, if implemented, would inevitably cool credit card spending.

Second, consumer sentiments are already on the wane with consumers increasingly concerned about jobs and incomes, the key fundamentals of spending, for the next six months. The MIER Consumer Sentiment Index, a leading indicator of consumer spending one to two quarters ahead, which has been heading south since the beginning of this year, has weakened further by 7.3 points in the third quarter from a quarter earlier. Apart from the loss of economic momentum, sentiments have been badly affected by the three hikes in gasoline and diesel prices this year that have eaten into consumers' budgets.

Inflation fears are also high, with 84 per cent of the respondents expecting higher prices in the coming months as high oil costs seeped into final prices of goods and services. The government has promised to temporarily hold down domestic energy prices until year-end, but some hikes are expected in 2006. Also, adding more to the jitters over inflation are the possible hikes in the tariffs for electricity and water next year. The net result of all these will weigh heavily on the sentiments for an already over-stretched consumer sector next year, given their sensitivity to any whiff of inflation.

Third, domestic interest rates, after being kept in a holding pattern this year, is expected to be raised next year, albeit by a modest 50–75 basis points, as further misalignment between domestic and US interest rate differentials and negative real interest rates domestically compel funds seeking higher returns to flow out. Already, capital is flowing out, as suggested by the fall in Bank Negara's foreign exchange reserves by US$79.4 billion during the first two weeks of October.

Fourth, job creation may disappoint. In theory, any recovery in the employment market would really depend on the strength of the recovery in real output. The evidence from the past three decades teaches us that an improvement in unemployment rate in the same year as the economic recovery requires real GDP growth to exceed its potential long-term trend. Otherwise, one would have to wait till the second year of the recovery for unemployment rate to improve. With the pace of economy recovery next year expected to fall well below its long-term potential growth of about 6 to 6.5 per cent, the recovery is therefore unlikely to be fast enough to give job creation a big enough boost.

The outlook could, of course, change if the recovery in exports turns out to be much stronger than what the government expects. After all, the economy is a lot more sensitive to the pull from external demand than consumption spending, which tends to grow incrementally with the overall growth in the economy and, therefore, could only go so far in propping up the economy in the absence of a recovery in external demand. But for now, against the expectation of only a modest recovery, a more subdued consumption spending, weighted down by higher fuel prices and inflation, weak sentiments, high household debt, inadequate job opportunities and rising interest rates would limit the upturn's oomph, resulting in real GDP growth undershooting the government's 5.5% projection.

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