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Avoiding the Twin Deficits in Malaysia

By G.Sivalingam

EXECUTIVE SUMMARY

- Prime Minister Najib Razak has pledged to trim the fiscal deficit to 4 per cent of GDP this year and 3 per cent in 2014. With a current account surplus and a fiscal deficit of about 4 per cent, Malaysia has been safe from being saddled with a simultaneous fiscal and current account deficit.

- The July 2013 downgrading of Malaysia's credit worthiness from positive to negative by Fitch Ratings was a clarion call to Najib's administration to avoid or lower the probability of the occurrence of a twin deficit. The Prime Minister immediately called for a restraint on imports as well as measures to reduce the fiscal deficit.

- There is also widespread speculation that the Goods and Service Tax will be introduced in the upcoming 2014 Budget to reduce the fiscal deficit. It is expected that the GST will be capped at 4 per cent to make it acceptable to the public.

- The Malaysian economy is not only vulnerable to the tapering of the stimulus by the United States but also its public debt as a percentage of GDP has drawn some attention and criticism. The ability of the government to service the debt will depend on income growth.

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- It is difficult to anticipate whether Malaysia will be saddled with a ‘twin deficits’ phenomenon. There is expectation that the fiscal deficit will persist but it is uncertain whether the current account surplus will be sustainable if the external demand for Malaysia’s manufactured goods, oil, palm oil and rubber does not increase in the near future.

- Given that the government has come to terms with the possibility of a fiscal and current account deficit occurring together, policy measures to prevent the occurrence of the ‘twin deficits’ is expected to be forthcoming.

INTRODUCTION

The 'twin deficits' has been the subject of concern for policy makers and economists across several countries. To maintain macroeconomic stability and sustain economic growth—according to the hypothesis—a country's current account deficit and budget deficit must be kept under control. Prime Minister Najib Razak has pledged to trim the fiscal deficit to 4 per cent of GDP this year and 3 per cent in 2014. With a current account surplus and a fiscal deficit of about 4 per cent, Malaysia has been safe from being saddled with a simultaneous fiscal and current account deficit. A twin deficit would have increased the likelihood of creditors demanding immediate payment while the probability that the country could satisfy such a demand would be low. This would constitute a signal that Malaysia was unable to service its debt and was on the verge of insolvency. It might lead to further withdrawal of funds or capital flight, depreciation of the ringgit and the collapse of the equity and bond markets. The end result would be a recession or a depression.

The recent downgrading of Malaysia's credit worthiness from positive to negative by Fitch Ratings functioned as a clarion call to Najib, who is also Minister of Finance, to avoid or lower the probability of a twin deficit. He immediately called for restraint on imports in light of the narrowing of the current account surplus. Obviously he was worried that the current account surplus would eventually turn negative if imports were not restrained. There has been the worrying sign that imports rose at a faster rate than exports in recent years (Bank Negara Annual Report, 2014, p. 29). Most of Malaysia's imports comprise of intermediate goods. The composition of consumer goods in the total import bill is about 8 per cent, whereas intermediate and capital goods comprise respectively about 61 per cent and 16 per cent of total imports. The remaining 15 per cent of imports is made up of other goods (Bank Negara Annual Report, 2014, p. 29).

The restraint on imports was also appropriate, as the ringgit had depreciated in recent months, making imports more expensive and exports less so. In other words, the capital flight associated with tapering by the Federal Reserve increases the probability that the current account surplus would narrow and eventually turn negative if external demand remained lackluster. The tapering or the end of quantitative easing would work on the current account through a depreciation of the ringgit. With tapering, ceteris paribus, the ringgit would depreciate because the demand for ringgit would fall as foreign hedge fund managers sell their ringgit holdings for dollars. Although the ringgit has depreciated by about 3.8 per cent this year, the Central Bank of Malaysia Governor has taken solace in the fact that "when you compare our currency with other currencies, it's been relatively stable" (The Star, 14 October 2013, Starbiz, p.4).

When the ringgit depreciates, imports become more expensive as they are denominated in US dollars. However, although exports become cheaper, an increase in export revenue is not guaranteed unless there is a corresponding increase in demand

for exports. If the demand for exports does not increase then a depreciated ringgit will make imports more expensive over time; and if export revenues are constant, then the current account will probably turn from positive to negative. With an existing fiscal deficit since 1998, Malaysia will then have to face the adverse consequences of a twin deficit if tapering leads to a further depreciation of the ringgit and the external demand for Malaysia's manufactured exports remains subdued.

The advent of the twin deficit may also raise the specter of a rise in off-shore speculation on the ringgit. To reduce the probability of off-shore speculation on the ringgit, the currency has remained de-internationalized since capital controls were introduced in September 1998. Although capital controls had been lifted since 2005, an enlightened Central Bank has seen it fit to keep the Malaysian Ringgit de-internationalized. The Central Bank of Malaysia Governor has gone on record to state that "in unstable international financial markets, we would not venture to internationalize the currency… We want to have a well-developed foreign-exchange market and while this has progressively improved it has not reached the stage where we believe that we should internationalize our market" (The Star, 14 October 2013, Starbiz, p.4).

REDUCING THE FISCAL DEFICIT

At the same time that the Prime Minister announced measures to reduce imports to maintain or increase the current account surplus, he also announced measures to reduce the fiscal deficit. Among the immediate fiscal measures was the increase in subsidized fuel gasoline prices and cigarette taxes. Cigarette prices have gone up by between 12 to15 per cent since September 2013. The restraint on imports also implied that inputs should be sourced domestically rather than be imported. To facilitate the reduction of imports, the Prime Minister also announced a delay in the implementation of public projects, especially capital-intensive one. These new policy measures were introduced way ahead of the General Assembly of the United Malay National Organization (UMNO), during which not much objections were raised, perhaps because they were considered small or not painful. At the same time, more controversial measures such as raising revenue by introducing new taxes has been delayed until after the UMNO General Assembly and may possibly be announced on Budget Day later this week.

There is also widespread speculation in the press that the Goods and Service Tax (GST) will be introduced in the upcoming 2014 Budget to reduce the fiscal deficit. It is expected that the GST will be capped at 4 per cent to make it acceptable to the public. It appears that the business community has accepted the GST as a *fait accompli*. To allay consumer fears, the government has been encouraged to spend millions on an advertising campaign to educate the public to accept and enjoy the benefits that will accrue to society as a result of introducing the GST.

The inevitability of the tax has been highlighted by various groups including Ministry of Finance officials and economists belonging to the neo-classical persuasion.

Najib's administration, however, is not very confident of implementing the GST this year and has adopted a cautious approach. He is waiting for the outcome of a Cabinet meeting just before the Budget Statement in Parliament to gauge whether there is "enough support to introduce a goods and service tax" (New Straits Times, October 15, 2013, p.B1). According to Prime Minister Najib, Malaysia is "one of the very, very few countries in the world which does not have a GST… But there are challenges. Anything to do with any new form of tax, like consumption tax in Japan, carbon tax in Australia, these are big issues that cannot be easily decided" (New Straits Times, October 15, 2013, p.B1).

Besides the GST, the Najib administration is also considering further reductions on state subsidies, increasing its tax base, improving the efficiency of tax collection, and introducing cost saving measures to reduce the fiscal deficit.

EXTERNAL AND INTERNAL VULNERABILITIES

An immediate concern for open emerging economies such as Malaysia is the danger of sudden changes in monetary policy in the United States. Even in less turbulent times, the Federal Reserve's monetary policy has implications worldwide because of the dollar's role as the global reserve and trading currency. Any signal of the tapering of unconventional monetary policy in the United States—commonly known as quantitative easing—may have negative consequences for the current account balance of open emerging economies. For example, the Federal Reserve Bank announced in June this year that it would start dismantling its stimulus programme through bond purchases because it expected its economy to recover. However, it decided last month to continue with the stimulus programme because of the disappointing jobs data.

The expectation is that the Federal Reserve Bank will not wait very long to wind down its stimulus programme, and it is anticipated that the repercussions of the tapering of the stimulus may be very serious for open emerging markets. A more restrictive monetary policy in the United States may cause the ringgit to depreciate further and the Bank Negara governor was reported to have said that repercussions "may be even more significant" and there was a need to expand the IMF's "policy toolkit" to deal with the problems open emerging economies like Malaysia are expected to face (The Star October 14 October 2013, Starbiz, p.8).

There have been calls for greater transparency in the decision-making process. Emerging market central banks may be able to take appropriate action to insulate themselves against any negative repercussions if changes to U.S. economic policy are gradually introduced, well flagged, and not start until the world has had more time to prepare for them. A recently held IMF governing panel "acknowledged the risks

posed by a transition toward more normal policies in advanced economies, and it urged nations not to delay preparations" (The Star October 14 2013, Starbiz, p.8).

The Malaysian economy is not only vulnerable to the sudden tapering of the stimulus by the United States, its public debt as a percentage of GDP has drawn some attention and criticism. Malaysia's relatively large public debt: GDP ratio of 53.3 percent was also one of the reasons behind the July 2013 downgrade of Malaysia by Fitch Ratings. The Najib Administration has a self-imposed sovereign debt ceiling of 55 per cent which it hopes not to exceed. The focus of the criticism has been on public debt as a proportion of GDP rather than on whether the debt is foreign or domestic or whether the government is able to pay the interest and principal that is due on the debt. Since much of the debt is domestic and interest rates in Malaysia are stable and low, the ability of the government to pay will depend on the rate of economic growth and growth in government revenues. The Najib Administration hopes a 6 per cent GDP growth rate next year will provide it with the wherewithal to service the debt.

Some of the concern over public debt in Malaysia has also been over debt accumulated by Malaysia's sovereign wealth fund, which is known as the 1Malaysia Development Berhad or 1MDB, which is chaired by the Prime Minister. Since its formation in 2009, it is estimated that it has accumulated RM30 billion in debt (The New Straits Times, October 15 2013, p.B12). However, its total assets exceed its total debt and the debt has been used for productive purposes, that is, the acquisition of energy assets and for the development of the Kuala Lumpur International Financial District or the Tun Razak Exchange. The ability of the government to service the debt will depend on income growth. Despite widely held beliefs, the monetary, financial and budgetary institutions in Malaysia appear to be in relatively good shape and not on the verge of breakdown.

CONCLUSION

It is difficult to anticipate whether Malaysia will be saddled with a 'twin deficits' phenomenon. The expectation is that the fiscal deficit will persist but whether the current account surplus will be sustainable if the external demand for Malaysia's manufactured goods, oil, palm oil and rubber does not increase in the near future, is unclear. Commenting on the concern among rating agencies about the twin deficit threat to Malaysia's economy at a conference in Nusajaya last week, Datuk Seri Abdul Wahid Omar from the Prime Minister's Department reiterated that the government will to continue its efforts to reduce the country's fiscal deficit and ensure its current account surplus is strong (Business Times, 21 October 2013). Given that the government has come to terms with the possibility of a fiscal and current account deficit occurring together, policy measures to prevent the occurrence of the 'twin deficits' is expected to be forthcoming and all eyes will be glued more than ever to Budget 2014 later this week.

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