Fiscal policy in Malaysia

V Vijayaledchumy[1]

1. Background

In the 1970s, the Malaysian government played a key role in the economy. The government ventured beyond its traditional functions and took on a more direct and active role in the country's overall social and economic development process. This period saw the government's direct participation in the private sector through the establishment of large commercial enterprises. Government participation in the economy expanded further in 1980-82 as it pursued an expansionary countercyclical fiscal policy aimed at stimulating economic activity and sustaining growth to ride out the effects of the global recession. The countercyclical policy led to "twin deficits" in the government's fiscal position and the balance of payments. When confronted with this twin deficit problem, the government implemented comprehensive structural programmes to reduce spending and reordered national objectives consistent with domestic resource availability and to ensure prudence in its recourse to external borrowing.

The new direction in public policy also sought to promote the private sector as the main engine of growth for the economy. The most significant development was the reduction of the public sector's commercial activities, implemented through the privatisation programme. Subsequently, government intervention has been largely in support of private sector initiatives towards overall development of the country. The tax structure was also reformed to increase international competitiveness as well as promote national savings to meet future levels of growth and investment requirements.

The shift in emphasis towards private sector-driven growth contributed to a marked improvement in the government's financial position as well as a reduction in its borrowing requirements. As a strengthened fiscal position emerged in the late 1980s, the government was able to prepay its external debt, thereby improving the nation's external debt profile. It also culminated in fiscal surpluses for five years during 1993-97. With the consolidation of public activities, the share of public expenditure to GDP declined to 21% in 1997, from a peak of 44% in 1982. The total debt level of the federal government was substantially reduced to 32% of GDP by the end of 1997, from a peak of 103% in 1986. The external debt of the government was also low, at 4.6% of GDP or 7.6% of total external debt in 1997. The prudent policies adopted accorded the government greater flexibility in implementing expansionary measures to support growth during the crisis years.

2. Fiscal policy response to Asian financial crisis

During the early stages of the Asian financial crisis, the government tightened budgetary operations to bring about a reduction in the current account deficit of the balance of payments and to reduce inflationary pressures arising from the depreciation of the ringgit. As the regional economic crisis continued into 1998, fiscal policy turned expansionary to support economic activity. The fiscal measures included a selective increase in infrastructure spending, establishment of funds to support small and medium-sized enterprises, a higher allocation for social sector development and a reduction in taxes. Special funds were also established or expanded to provide credit to priority sectors at concessionary rates. The fiscal stimulus package was MYR 7 billion or 2.5% of GDP, of which MYR 1 billion was allocated for social safety net measures to mitigate the impact of the crisis on the poor. As a result of these measures, a fiscal deficit of 1.8% of GDP emerged after five years of surpluses.

[1] All views expressed in this paper are solely those of the author and do not necessarily reflect those of Bank Negara Malaysia.

As global economic uncertainties continued to persist, the 1999-2003 budgets maintained an expansionary stance, with the authorities conscious of the need to maintain debt sustainability. The countercyclical fiscal policy, implemented largely through discretionary measures, was effective in supporting economic recovery and sustaining domestic demand. In particular, when external demand contracted significantly in 2001, Malaysia was still able to record a positive growth rate. The effectiveness of fiscal policy was also supported by other strategies and policies that continue to build on Malaysia's strong economic fundamentals.

3. Analysis of fiscal accounts, 1998-2002

Malaysia keeps all policies under constant review, to respond to changing circumstances. During 1998-2002 monetary conditions also supported the expansion of private sector activities. Interest rates were cut to historically low levels in 1999, with the intervention rate reduced by 550 basis points. Following the events of 11 September 2001, it was cut by a further 50 basis points. In pursuing expansionary demand management policies, care was taken that fiscal and monetary measures would not unduly risk creating imbalances which might jeopardise the long-term growth potential, price stability or gains made in achieving a robust balance of payments. Given that the exchange rate is pegged, the government is fully committed to ensuring that the overall stance of macroeconomic policy is consistent with and supportive of the exchange rate regime to ensure its sustainability. In this regard, both fiscal and monetary policies have been carefully applied to support economic recovery, whilst preserving Malaysia's economic fundamentals.

In determining the size of the fiscal deficit, major considerations are:

- ensuring that revenue is able to meet operating expenditure and hence, that a surplus in the current account is maintained at all times;
- ensuring the availability of domestic and external financing without crowding out the private sector;
- ensuring that debt servicing does not exceed 20% of total operating expenditure.

Overall, to ensure that public debt remains at manageable levels, a legislated borrowing rule stipulates a ceiling for federal government debt.

4. Impact of fiscal expansion

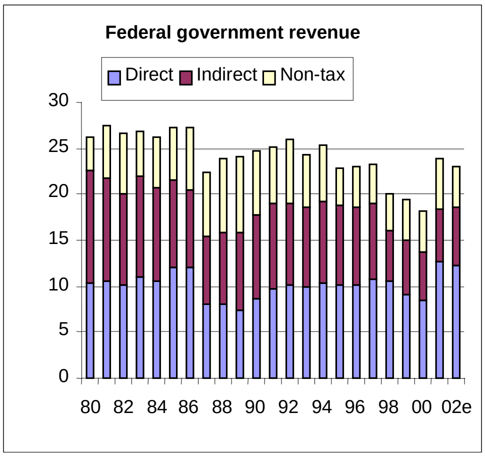
Size of the overall budget

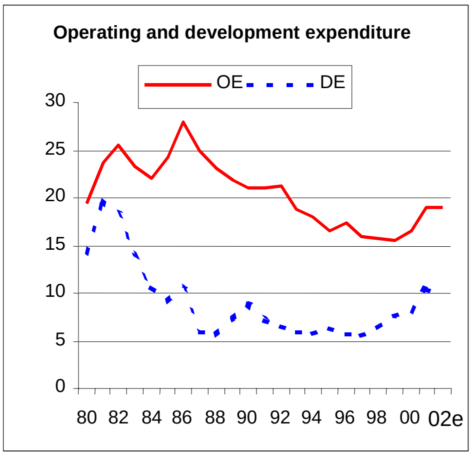
Following the implementation of fiscal stimulus packages, government spending increased from an average of 22% of GDP in 1995-97 to 30% in 2001, or an average of nearly 25% of GDP during 1998-2001.

On the revenue side, receipts have remained robust, providing flexibility for increases in development expenditure without exceeding the size of the overall deficit. The improvement was due to an ongoing tax reform programme aimed at improving tax buoyancy and tax receipts as well as increases in petroleum-based revenue, arising from higher oil prices. Petroleum-based revenue accounts for about one fifth of total revenue. In 2001, revenue collected recovered to the pre-crisis level of 24% of GDP, having averaged only 19% of GDP during 1998-2000. Non-tax revenue (20% of total revenue) was relatively stable at about 4-5% of GDP during the crisis period. Consequently, the overall fiscal deficit has been contained at below 6% of GDP.

Graph 1

Federal government revenue and expenditure[1]





[1] As a percentage of GDP.

Source: Ministry of Finance.

Nature of the fiscal deficit

To evaluate fiscal risks, it is important to determine the nature of the deficit. Estimates of derived cyclically neutral balance, based on a structural balance concept, indicated a deficit of less than 1% of GDP, compared to an average deficit of about 4% of GDP during 1998-2002. The fiscal stance adjusted for the cyclically neutral stance remained positive, indicating that the fiscal policy was adding stimulus to the economy. In estimating the cyclically neutral balance, 1995 was selected as the base year, as actual and potential GDP were at about the same levels. The fiscal stance indicated a policy deficit induced by the countercyclical measures taken by the government, and not induced by longer-term structural rigidities arising from either locked-in operating expenditure or a persistent decline in revenues due to inefficiency in collection or weak fundamentals. Hence, the impact of the measures on the fiscal balance is expected to be only transitory. As the fiscal stimulus largely comprised higher development expenditure, the capacity to move towards a surplus is greater when economic activities recover. Revenue growth during these years has also remained favourable, reflecting the strong underlying economic fundamentals.

Table 1

Fiscal accounts

As a percentage of GDP

	1997	**1998**	**1999**	**2000**	**2001**	**2002e**
Overall balance (budget definition)	2.4	–1.8	–3.3	–5.8	–5.5	–4.7
Primary balance	4.6	0.7	–0.5	–3.1	–2.6	–2.0
Cyclically neutral balance (base year 1995)	0.7	–1.9	–0.7	0.2	–0.4	–0.1
Fiscal stance	–1.7	–0.1	2.4	6.0	5.1	4.6
Fiscal impulse	–2.0	1.6	2.5	3.6	–0.9	–0.4
Revenue	*–0.4*	*3.3*	*0.5*	*1.4*	*–5.7*	*0.3*
Expenditure	*–1.6*	*–1.7*	*2.0*	*2.1*	*4.8*	*–0.7*

The fiscal impulse, which measures the changes in fiscal stance, was positive during the years 1998-2000. A negative fiscal impulse was registered in 2001. In that year, two additional fiscal stimulus packages, of MYR 3 billion in March and MYR 4.3 billion in September, were introduced to minimise the impact of adverse external developments on the domestic economy. The second package was focused on smaller projects which could be implemented immediately. While the increased government expenditure provided a cushion from the impact of the global economic slowdown, the stronger revenue outturn reduced the fiscal stimulus.

More importantly, the fiscal expansion has not created structural imbalances in the economy. Government spending has not resulted in higher inflation due to the excess capacity in the economy. Similarly, government spending has not resulted in leakages and put a strain on the balance of payments as most of the expenditure was on projects with minimal import content. Thus, no stress was imposed on the current account of the balance of payments. Expenditure was carefully managed to strengthen domestic demand. Projects selected under the fiscal stimulus programmes were those with strong linkages to the economy, while meeting socio-economic objectives. About 27% of the expenditure was on education and training, which not only stimulated economic growth in the near term but also help enhance the long-term objective of raising productivity.

Table 2

Selected economic indicators

	1997	**2000**	**2001**	**2002e**
Monetary growth M3 (% growth)	18.5	5.0	2.9	6.2
CPI (% growth)	2.7	1.6	1.4	2.1
Current account balance (% of GDP)	–5.9	9.4	8.3	6.5
Domestic private investment (% of GDP)	31.8	12.8	10.3	13.2
Debt service charges of the Federal Government (% of GDP)	2.3	2.7	2.8	2.7

The high savings rate and excess liquidity in the system made it possible for the bulk of the fiscal deficit to be financed through non-inflationary domestic sources in the form of Malaysian government securities. The large issuance of these securities was subscribed mainly by provident, pension and insurance funds. As there was sufficient liquidity in the banking system to meet the private sector's financing needs, the government requirements did not result in any crowding-out effects.

At the same time, it also reflected that the government has never resorted to monetary financing of the deficit that would lead to money creation.[2] Given adequate domestic resources, financing from abroad continued to be an option, determined mainly by cost factors and the need to establish a market presence and provide a benchmark for the corporate sector.

Debt sustainability

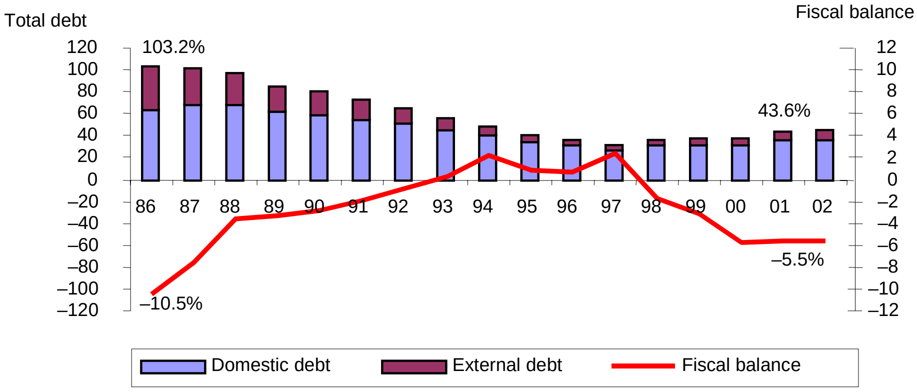
The government has remained committed to the adherence to specific rules related to the fiscal balance (maintaining an operating surplus and other fiscal rules over a longer time horizon which are predetermined in the five-year development plans). This commitment, together with strong underlying fundamentals, has enabled the government to contain debt at a manageable level. The deficit has been kept below 6% of GDP and the total federal government debt below 50% of GDP. Debt servicing remains low, at 14.6% of operating expenditure (11.6% of total revenue or 2.7% of GDP) in 2002, and

[2] There are legal limitations as to the amount and duration of loans that the central bank can make available to the government. The Central Bank Act of 1958 stipulates that the advance should not exceed 12.5% of the budget revenue of the government and must be repaid as soon as possible, and not later than three months after the end of the financial year in which it is granted.

has not constrained fiscal flexibility. Furthermore, as the bulk of government borrowing has been from non-inflationary domestic sources (81% of total outstanding debt is in ringgit), the government's exposure to exchange rate risks has been kept low. Given that the bulk of the borrowings (76%) are raised at fixed interest rates, the exposure to interest rate changes is also low. In addition, about 60% of the debt has a maturity of more than three years and it is adequately spaced out to minimise risks from bunching.

Graph 2

Sustainable fiscal and debt levels[1]



[1] As a percentage of GDP.

Source: Ministry of Finance.

Table 3

Federal government debt indicators

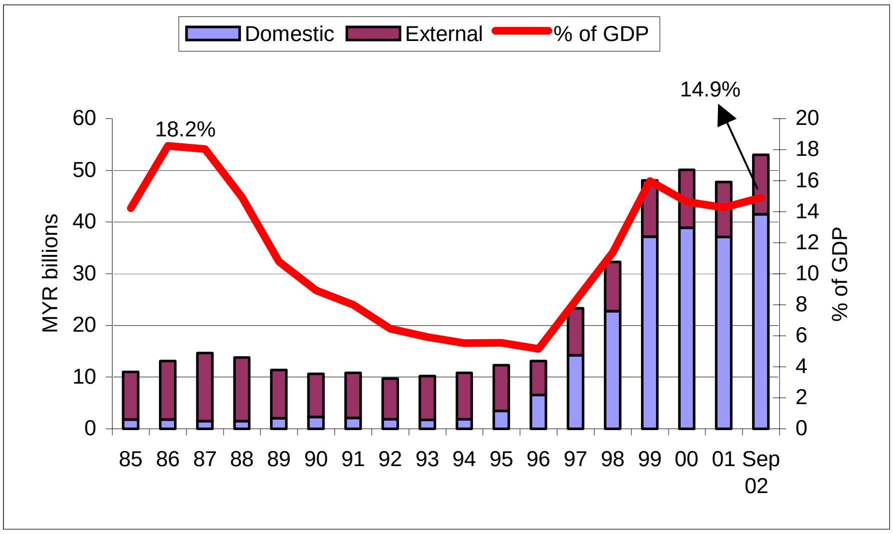
	Fiscal deficit	Domestic[1]	External[1]	Total debt[1]	Debt servicing	External debt servicing ratio
	(% of GDP)				(% of operating expenditure)	(%)
1997	2.4	27.3	4.6	31.9	14.4	0.7
1998	–1.8	31.1	5.3	36.4	15.5	1.0
1999	–3.2	31.1	6.1	37.3	17.0	0.7
2000	–5.8	31.2	5.5	36.7	16.0	1.2
2001	–5.5	36.3	7.3	43.6	15.1	0.5
2002 H1	–3.1	34.5	8.1	42.7	18.9	0.6

[1] Refers to end of period.

The government's drive to reinvigorate and strengthen the economy included financial and corporate restructuring exercises as well as issuance of bonds by Khazanah Malaysia, the federal government's investment arm, aimed at providing a benchmark for ringgit bonds. As a result, the guaranteed debt of the government increased from MYR 23 billion, or 8.3% of GDP, at end-1997 to MYR 48 billion, or 14.3% of GDP, as at 2001. This is not expected to have any adverse impact on fiscal sustainability. Most of the debt guaranteed was for companies that would be able to generate sufficient revenue to meet their obligations. Nevertheless, in an environment of external uncertainty, the government is strongly committed to monitoring potential new obligations very closely to contain the contingent liabilities and thereby minimise financial risks.

Graph 3

Guaranteed debt of the federal government



Source: Ministry of Finance.

During 2001-02, as part of the efforts to accelerate corporate restructuring and encourage private sector activities, the Malaysian government had been directly involved in the restructuring of a few large corporations of strategic and national interest via the Corporate Debt Restructuring Corporation, special purpose vehicles and the appointment of professional managers. This move, however, would not have a significant impact on the government's budget and debt level. Funding for the special purpose vehicles was largely through their issuance of bonds, a large part of which did not require government guarantees. The affected companies are undergoing both debt and operational restructuring to ensure their continued viability. Therefore, there is limited risk to the authorities of an increase in expenditure on these contingent liabilities.

Fiscal policy flexibility

Discussion on the fiscal flexibility of Malaysia has always centred on the unwritten fiscal rule of maintaining a surplus in the current account, the annual budget formulation process and the greater reliance on discretionary measures rather than built-in stabilisers to address cyclical developments. Such a stance has been considered to accord less fiscal flexibility in times of crisis. In this regard, Malaysia has always reiterated that the prudent stance of maintaining at least a surplus position in the current account over the course of the business cycle reduces the longer-term risks for the country. Malaysia is not convinced of the merits of introducing unemployment and social security benefits because such measures have proven to be costly in other countries. Moreover, the existing informal social safety net is considered adequate. The aim is to move towards a fiscal surplus over the medium term to provide more effective built-in stabilisers and allow the use of discretionary measures at appropriate times to protect employment and social cohesion.

In implementing the current fiscal stimulus programme, Malaysia did face implementation constraints initially. Hence, existing procedures were adjusted in order to enhance the efficiency of project implementation, speed up payments to contractors and remove bureaucratic delays. Besides a review of procedures, rules and guidelines on the implementation of development projects, procurement and payment to contractors, the implementation of projects was also more closely monitored. The government is planning to move towards a broad-based consumption tax, although the timing will depend on economic conditions. Meanwhile, measures have been implemented to gradually widen the scope and coverage of sales and service taxes.

Recognising also the merits of moving towards multi-year planning in the budgeting process, beginning with the 2003 budget the budget preparation and examination process will be carried out once every two years instead of annually.

5. Conclusion

A strong commitment to fiscal sustainability is critical for macroeconomic stability as well as to ensure sustainable long-term growth. Malaysia continues to enjoy flexibility in expanding its fiscal position, which remains sustainable given the government's fiscal prudence and discipline. The impact of countercyclical measures on the fiscal deficit is expected to be transitory. The government, as part of the fiscal prudence policy, will closely monitor its spending. Over the medium term, its fiscal position will be consolidated as the economy recovers and is able to expand at its own momentum. The pace of consolidation will be guided by developments in external demand and domestic economic developments, with a focus on medium-term public debt sustainability considerations.