

CHAPTER 1: OVERVIEW

1.1 Introduction

Budget imbalances are frequent and tend to reflect the business cycle in an economy, but long and pervasive imbalances invariably raise the risk of the ability of an economy to cushion itself against any adverse macro-economic development. There has been an ongoing concern that the worsening fiscal position of the government of Malaysia with the increasing level of government's debt is simply unsustainable, and there is a pressing need for the government to rein in its spending.

The purpose of this research paper is to look at the long term and medium term risks of fiscal sustainability in Malaysia. The common method used to test the long term sustainability of a fiscal policy is the stationary test for government's fiscal position and debts as well as the co-integration test for government's revenue and expenditure. Medium term sustainability test tends to focus on the so called "Indicative Threshold Approach" and a set of fiscal sustainability indicators. Under this approach, where a threshold is breached, the fiscal position is considered as in a danger zone.

1.2 Objectives

This paper attempts to look at the issue of fiscal sustainability in Malaysia from the longer term and medium term perspectives and also evaluate the policy

adjustment that is required for a sustained fiscal policy in the country. The first segment of the analysis relates to assessment of longer-term risk by looking from the perspective of whether the government finances (more precisely, the federal government) are in line with the inter-temporal budget constraint that is required for the government budget process to be sustainable. The test looks at the government finances including its revenue, expenditure and its fiscal position over a long period of time and asks whether lenders may take an unfavourable view of continuously lending to the country. The investigation centered on applying econometric test of unit root and cointegration analysis to evaluate whether the Present Value Budget Constraint condition ("PVBC") holds for the case of Malaysia. The fulfillment of the PVBC condition suggests the sustainability of the fiscal policy. The series are tested for unit root and subsequently proceed to test for co-integration of government revenue and expenditure, if they are found to be non-stationary. It is important that not only the fiscal position is tested for unit root because if the test of the government fiscal position shows that the series is not stationary, the PVBC position will still hold if the debt series is stationary (Trehan and Walsh, 1991, Pg 206-223). The purpose for the co-integration test is that even if the two series of government revenue and expenditure are non-stationary, so long as they are co-integrated, the PVBC condition can still hold and the fiscal policy is still sustainable (Hakkio and Rush, 1991, Pg 429-445).

For assessing the medium term risk of corrective adjustment, we look at a set of fiscal sustainability indicators. The second part of this paper moves on to look at a set of fiscal indicators and notably various test ratios to examine the issue of sustainability. This is an indicative threshold test in which in the event that certain threshold is breached, the fiscal position will become questionable. In doing this, studies from IMF (Geithner, Timothy, 2002, IMF, Pg 42-44) are employed as yardsticks for comparison with our data on Malaysia. In this section, we also discuss the level of overall fiscal deficit and primary deficit that need to be achieved for the debt-to-GDP ratio to stabilize. There are also discussion and analysis of whether the government has resort to seigniorage revenue to fund the deficit and whether this will result in rising inflation. This is because the use of seigniorage revenue through the expansion of monetary base may hasten the case of unsustainable fiscal policy. The final section evaluates the domestic financial sector through the various Financial Sector Stability Indicators. The section is rest upon the inter-link and the importance of financial sector and fiscal sustainability. There is a close interlink between financial sector stability, external debts and the sustainability of fiscal policy. The financial system tends to be the pillar of the economy and government often act as the guarantor to its health. On the other hand, a massive government and external debts may cause broader financial instability. (Geithner, Timothy, 2002, IMF, Pg 22)

1.3 Data Sources and Description of Study

Although the real variables are more frequently used in the previous studies, we have decided to test for both the real and nominal series for our purposes. Our empirical test is conducted through examining the series of federal government's revenue, expenditure, fiscal position and debts. In this respect, we divided the time series into three sub-groups. The first sub-group is the combined series from 1970-2003 while the second and third sub-groups are series for pre-crisis between 1970-1997 and post crisis between 1998-2003 respectively. These series are also converted into real series by taking the Consumer Price Index as the basis for conversion. For the 1998-2003 post crisis series, because of the low frequency of the data points, we adopted the quarterly data as the basis of our test. These quarterly series are adjusted by taking 4-quarterly moving averages to smoothen out the seasonality.

For the section on the Fiscal Sustainability Indicators, the time series are annual data. The federal government debts are the same as the above while the debts of Non-Financial Public Enterprises are derived from the annual report of Bank Negara Malaysia.

All data were obtained from official sources published by Bank Negara Malaysia, including BNM annual report, BNM Monthly Statistical Bullentin and Economic Report published by Ministry of Finance Malaysia. For international data, we

obtained these from International Financial Statistics published by International Monetary Fund.

1.4 Organization of Study

This paper is divided into 6 chapters:

Chapter 1 provides an overview of the purposes and objectives of this paper.

Chapter 2 looks at various literature review on fiscal sustainability, including the statistical test of inter-temporal budget constraint and indicators of fiscal sustainability.

Chapter 3 discusses the methodologies for testing and analysis. The results and analysis are included in Chapter 4 and Chapter 5.

Chapter 4 discuss the results and analysis of statistical test of inter-temporal budget and

Chapter 5 gives the results of fiscal sustainability indicators.

Chapter 6, the final chapter concludes the findings of this paper.