CHAPTER 6: CONCLUSION

6.1 Introduction

This research paper investigates the long term and medium term fiscal sustainability in Malaysia. The study explores the long term sustainability from the perspective of intertemporal budget constraint whereby the statistical tests of unit root and co-integration are conducted over three sub-periods of pre-crisis, post-crisis and combined periods. For the medium term, the indicators of fiscal sustainability test are adopted. This includes indicative threshold test for debt-to-GDP, primary gap ratio and financial sector stability indicators.

6.2 Summary for Long Term risk of Fiscal Sustainability: Testing Inter-temporal Budget Constraint

The results of the unit root and co-integration test for the series, Debt, Expenditure, Revenue and Fiscal position implied that the PVBC condition does not hold in the case of Malaysia. The debt, revenue, expenditure and fiscal position are non-stationary based on the Augmented Dickey-Fuller test, which showed the existence of unit root in all the four series. Further test on co-integration of Revenue and Expenditure series while show that there could be one co-integrating equation for the series 1970-1997 however, it failed to conclusively support the presence of co-integrating equations for the other two series of 1998-

2003 and 1970-2003. This further reinforces by the unit root test on the fiscal position series, which indicates non-stationarity of the series.

Trehan and Walsh (1991) indicated that if the test of the government fiscal position shows that the series is not stationary, the PVBC position will only hold if the debt series is stationary. Unfortunately, this is not the case for Malaysia. The test does not satisfy the conditions laid down by Trehan and Walsh (1991) as both the fiscal series and debt series are non-stationary. Hence, it can be concluded that the PVBC condition does not hold for the case of Malaysia for the period tested, indicating that Malaysia's fiscal policy is not sustainable in the long run.

6.3 Summary for Medium Term risk of Fiscal Sustainability: Indicators of Fiscal Sustainability

The conclusion drawn from the analysis of the external debt-to-GDP ratio suggests that the external debt threshold limit of 40%, which if breach would have raised the probability of default and crisis, has now again moving upwards after converging to a more sustainable level prior to the Asian Financial Crisis from the period between 1987 to 1997. The ratio converges from its high of 55% for external debts including NFPE and 34% for external debts excluding NFPE in 1987 to a low of 16% and 4% respectively in 1997. It gradually rises again to 27% and 10% respectively in 2003.

The headline Government external debt-to-GDP ratio remains convincingly low at 10%, suggesting that it has capacity to undertake further external borrowings. Even in a worse case scenario of sub-par economic growth of 1% and an explosive 15% growth in external debts, the threshold can remain below 40% at least up to 2017. But if the NFPE's external debts are included in the analysis, the tolerance of the external debt-to-GDP ratio fell substantially. In our base case assumptions with the inclusion of NFPE's debt, the threshold may be breached in year 2011.

The above results are very precarious in the sense that the empirical test on the sustainability of the debts and fiscal position suggested that the past policy is not sustainable. At the same time, the low external debt-to-GDP ratio indicates the ability of the Government to undertake further external borrowings at least for some years to come before the threshold risk is tested.

With the appropriate mixed of the source and type of borrowings, the Government has proven that it can extend the number of years it takes to breach the threshold. Firstly, by resorting to a different source to borrow, i.e. using NFPEs as borrower, the Government is able to off load its borrowing from its balance sheet but at the same time backed those borrowings with the assets of the NFPEs. This invariably boosted the Government's capacity to borrow while keeping the external debt-to-GDP at a level consistent with international standard of fiscal prudence.

This is apparently reflected in the numbers. Had the Government undertake to borrow for the NFPE, the external debt-to-GDP would have risen from 9.5% to 27%. In a spirit of the debt-to-GDP analysis on a base case scenario of 11.5% growth in external debts and 6% GDP growth, the number of years to breach the threshold level would have been shortened from 2032 to 2011, by almost 21 years.

Secondly, domestic debts market has been able to support and fund the fiscal shortfall without severely resulting in a crowding out of private sector. Government is able to keep its external liability and the external debt-to-GDP ratio under control with the stronger ability to raise fund from the domestic market. Such a strategy works if there is little ramification on the domestic economy arising from the use local borrowing. The concerns that domestic borrowings may result in higher inflation and crowding out effect are tested.

Our seigniorage analysis clearly shows that despite the fact that the federal Government has been borrowing more locally post crisis, there is also strong degree of independence from the monetary authority not to finance the borrowing from printing money. Over the years, Reserve money-to-GDP is relatively low at only about one tenth of the debt-to-GDP, indicating the limited ability to use reserve money to fund debt borrowings. If this is being done, the reserve money would have been expanded at a larger level to offset the increase in borrowings due to its relatively low base. Our analysis shows that at the peak of the

seigniorage used in 1996, the seigniorage effect is only 3.1% of GDP, and even that was on the back of strong economic growth of 10%. This suggests that the increase was likely catered for stronger economic growth than for funding the borrowings. The effect is even much lower after Asian Financial crisis. Seigniorage average about 0.6% of GDP, that's on the back of a stronger domestic debt expansion of average 12%. The low expansion in reserve money on the back of higher domestic debt growth indicates a case of negligible seigniorage effect. This independence has since kept the inflation in check over the years.

Also, there is no reason to suspect the existence of crowding out effect on private sector because the banking system remains flush with liquidity and interest rates continue to stay low – not the signs of crowding out. Furthermore, the financial sector appears to be healthier and on a stronger footing to support a larger loan expansion. The Risk Weighted Capital Adequacy Ratio is at its highest level, while NPLs seem to be trending down and stabilizing at a manageable level. Returns are also improving and the merger and stricter regulatory oversight all seem to suggest local financial institutions have stronger capability now to expand its loan base to private sector and hence reduce the likelihood of crowding out effect.

The analysis shows that for the debt-to-GDP to stabilize, the economy must be able to sustain at a growth rate of 6.9% and above, otherwise, the fiscal authority must strive to cut its fiscal deficit to a lower level. Since GDP growth is

exogeneous and dependent on the external development, the prudence policy will be to cut fiscal deficit to a more manageable level. The analysis indicates that the manageable level of overall fiscal deficit is at 1.6%. At this level of fiscal deficit, the debt level is able to stabilize so long as the economy can expand at the estimated steady state growth rate of 4.3%.

Since, interest rate is subjective because of its variability over the years, the analysis is further expanded to consider the primary gap. Here the question is at what level of primary gap will the debt-to-GDP stabilizes? The study shows that for the current debt-to-GDP level to sustain based on the steady state parameters, Government must at least reduced the primary deficits from the current level of 1.6% to 0.3% or alternatively, to grow the economy consistently by at least more than the 4.3% growth rate under the steady state requirement. The Government has been able to growth the economy exceeding the 4.3% in recent year with the latest year GDP in 2004 set to hit the official forecast of 7%.

Nonetheless, since economic growth is very much exogenous, it is more likely to suggest that fiscal sustainability requires the reduction of the primary deficit level rather than increasing the economic growth rate in the medium term. Only such reduction wouid not undermine the Government fiscal consolidation plan as the cyclicality of the economic growth would only implicate the worsening of the need to cut the primary gap more than required during the downturn. This is because during the economic downturn, revenue collection tends to be lower and

expenditure tends to expand faster because of the counter cyclical measures implements by the Government. This will widen the primary gap and hence make it difficult to achieve a stable debt-to-GDP ratio.

6.4 Policy Implications

Table 6.1: Deviation of Development Spending Under Malaysia Plans

	5MP	6MP	7MP	8MP
Original Allocation	40,075	55,000	67,500	110,000
Revised Allocation	37,290	58,500	103,565	170,000
Actual	35,300	54,705	99,037	-
% deviation from Original Allocation	-11.9	-0.5	46.7	54.5

Looking at the past 4 Malaysia Plans, there is a high tendency for the fiscal authority to overshoot its development spending. Table 6.1 above shows that in the past two 5-year plan, Malaysia development spending has overshot its initial target by as much as more than 45% from it original target. This is quite in contrast with the 5MP and the 6MP where the spending was right in line with the original target. As a result of this, Malaysia's budget has been in deficits over the past 7 years with recent years of 2002 and 2003 hitting above 5% of GDP.

The result of the statistical study of PVBC shows that the past fiscal policy of Malaysia is unsustainable. The deficit and the debt level are not stationary and points to the risk that the past fiscal policy if continues into the foreseeable future, may expose the economy to the risk of corrective shocks. The fact that the Government has been running fiscal deficit for the past 7 years and expected to do

so for at least the next 2-3 years while the federal government debts are on the rise indicate the rising risks of fiscal sustainability concern.

This is even more critical in an environment where the Ringgit is still peg to the USD. The Ringgit peg reduces domestic monetary policy flexibility while at the same time fiscal deficit restrained the ability of the fiscal authority to adjust to changes in the economic cycle.

However, this does not mean that Malaysia fiscal position cannot accommodate further fiscal stress. There is still some way to go before the external debt-to-GDP ratio hitting the ever-important 40% threshold set by the IMF. The use of domestic borrowing and NFPE as a source of borrowing has prolonged the reach of the threshold. There is also no sign that monetary authority is aiding the fiscal authority in financing the deficit, suggesting a relatively independent monetary regime and a more subtle effect of the use of domestic borrowing on inflation.

It is not unusually for lawmakers to put down specific legal binding rules to force fiscal authority to achieve the objectives. The U.S. has "Balanced Budget and Emergency Deficit Control Act" in 1985 and "Budget Enforcement Act" in 1990, Europe has the "Stability and Growth Pact", Japan "Fiscal Structural Reform Act" 1997 and India recently implemented "The Fiscal Responsibility and Budget Management Act". If it is proven for the budget deficit in Malaysia to move towards a sustainable level, a specific legal binding rules can be considered

although such a rule is not necessary at this juncture as the government seems committed to narrow the budget deficits.

In brief, the study concludes that the past fiscal position is not sustainable in the long run but Malaysia still has some liberty to move towards the objective of fiscal consolidation. While the use of domestic borrowings has prolonged the life of fiscal position, there is a risk that this will ultimately compromise growth when inflation finally surfaces, if the fiscal position is not reverse in the long term.

6.5 Limitation of Study

The data points for the empirical results were based on a period of 23 years and were divided into three sub-groups of lesser frequency. The limitations of data points may increase the sensitive of the study and influence the outcome of the test. In the case of the Indicators of Fiscal Sustainability test, the results of the study are sensitive to the assumptions made. Changes in these assumptions such as the interest rate, inflation, money supply and growth rate may derive in a substantial different conclusion.