BOOSTING ECONOMY VIA DOMESTIC CONSUMPTION

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Bank Negara Malaysia (BNM) had its monetary policy committee (MPC) meeting on Jan 19 decided to maintain the overnight policy rate (OPR) at 3%. Last July, BNM made a surprise move to cut the OPR rate from 3.25% to 3% after seven years. The last cut was in 2009 during the global financial crisis.

The global economic outlook is seen bleak and gloomy. Donald Trump's election as US president, post-Brexit fallout, worsening political crisis in Europe, low crude oil prices and weakening emerging economies all contribute to the pessimistic environment nationally and globally. On the domestic front, subsidy rationalisation and perceived high cost of living may further dampen domestic demand.

Weak external demand is the main reason BNM maintained the OPR rate in order to sustain liquidity in the economy. OPR is a general interest rate used by large banks to borrow and lend from one another in the overnight market. OPR is one of the monetary policy tools to control liquidity in the money market. Changes in the OPR influence aggregate demand via consumption, investment and international trade. Increase in the OPR reflects tightening monetary policy and vice versa.

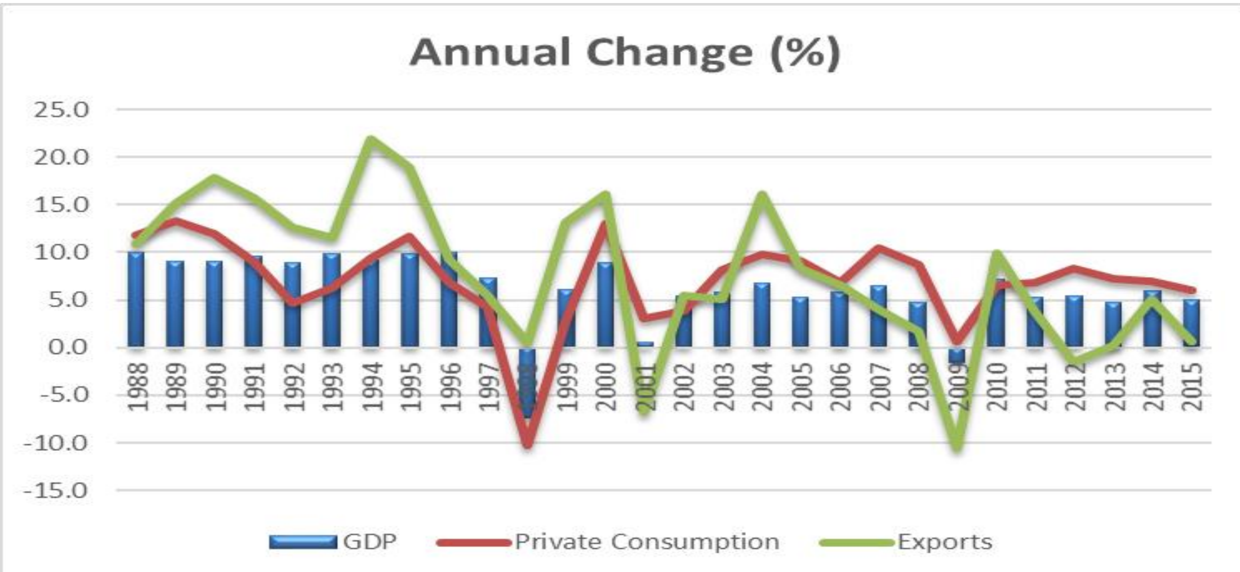
The MPC meeting highlighted the importance of private consumption in boosting the domestic economy. The strength of private consumption is essential to compensate the slumping external demand. With the continued wage and employment growth, private consumption is likely to remain viable in the short and medium terms.

The latest third quarter data show exports of goods and services shrank by 1.3% on an annual basis, recording lower than average 2015 exports performance. In fact, exports

[1] The views and opinions expressed herein are those of the author and do not necessarily reflect the views of MIER.

for 2015 were already slow with a growth of 0.6% as compared to 5% in 2014. Weak commodity prices and moderated global growth are main factors for the weakening external sector.

Stimulating private consumption is a sensible option, given the current macroeconomic situation. Private consumption constitutes about 50% of total GDP. Domestic demand, comprising consumption and public and private investments represent about 90% of GDP in 2015.



Source: Department of Statistics Malaysia

Referring to the recent economic recessions, private consumption was the drag factor in 1998 while exports in 2009. Exports have a huge influence the economy as exports-to-GDP ratio was close to 85% in 1998 and 2009. However, shares of GDP have changed since 2009 with private consumption rising from 48.4 in 2009 to 52.4% in 2015 whereas net exports shrank to 8.6% in 2015 from 18.5% in 2009.

Both economic recessions were due to external factors. In 2009, the recession originated from the financial crisis in the United States. Thus, the crisis hit the world economy, stifling global demand. On the other hand, the Asian financial crisis of 1998 affected only Asian countries. The impact on external sector was more rigorous in 2009 than in 1998.

The outlook for this year is quite gloomy due to uncertainty in the global economy. Global crude oil prices nosedived in 2014 and are expected to stay between US$50 (RM222) and US$60 per barrel. Despite OPEC and non-OPEC countries agreeing to limit production, such agreements are usually fragile and ineffective.

Individual producers tend to renege on the agreement, especially when oil prices rise, by raising production beyond the agreed limit. Plus, better production efficiency by shale oil producers could flood the market, thus limiting price increase. Weak global demand will also impede rise of oil prices.

Adding to the global uncertainty, geopolitical risks are much more challenging with the rise of protectionism in advanced economies. Trump's victory, Brexit and possibility of Quitaly and Frexit (Italy and France leaving the EU) could cause more market instability in Europe as well as the world. Slow growth of the global economy will cause trade to shrink, thus affecting growth of emerging countries. Even the International Monetary Fund (IMF) had revised down its forecast on world trade volume for last year and this year.

Apart from monetary tool, there are several measures particularly on fiscal tools that can be taken by the government to boost and sustain the economy through domestic demand. In the short and medium terms, cut in taxes such as goods and services tax, personal income tax and corporate tax would encourage domestic spending via private consumption and investment.

With the recent agreement on global oil production, the government may benefit from higher oil-related revenue in the near terms as global oil prices improved. Despite cutting oil production by 20,000 barrel per day, our export revenue is expected to increase through higher value of crude oil exports revenue and also other commodity-based exports.

Construction of mega public infrastructure projects such as Pan-Borneo Highway, Mass Rapid Transit (MRT), High Speed Rail (HSR) and others are expected to have positive spillover and multiplier effects on the economy through greater output, income and employment.

Direct transfer payments (such as BR1M) may help those in the lower income group and the needy to spend and survive in the challenging economic environment. In order to encourage spending, the payment should be provided more often rather than once a year. It is also better to provide direct subsidy to the targeted groups by providing an efficient and transparent delivery system.

As for external trade, Malaysia has to remain with its open door policy. Productivity and efficiency improvements in exports-related industries are crucial to ensure the economy remains competitive in global trade chains. Productivity level in the exports-related industries must move up and shift towards producing high value-added products. Special incentives should be given more to local SMEs to expand from small-scale to large-scale production.

Even though global economy is threatened with protectionism, Malaysia has to make smart and strategic moves in the global market. International trade still remains as an important channel to uplift the economy. With the current readjustment of major economies, in particular the US and United Kingdom, there are opportunities through direct or indirect trade deals with these economies.