2002 BUDGET – Looking To Inner Strength

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The government has unveiled a fairly comprehensive and expansionary budget for next year that cut across many sectors of the economy such as agriculture, shipping, tourism and resource based industries. The Budget, as we all know, was drafted against the background of a hostile economic environment. Before even having fully recovered from the 1997-98 Asian crisis, Malaysia's path to economic recovery was again sidetracked by a global technology bust. And lately, new difficulties pose by the US-Taliban conflict, threaten to cause another downward lurch in exports earnings.

Dealing with the traditional ups and downs of the business cycle, in itself, is already difficult enough. But now the task of policymaking has been made much more complicated by new factors such as the psychology of fear, whose impact would surely be very difficult to quantify. How the business down-cycle and the fear factor would combine to affect both business and consumer confidence in the US and around the world remains a big open question. At this moment, there is no credible economic model that could help us gauge the economic fallout of the recent episode. And with no parallels to draw upon for comparison in recent history, the drafting of the Budget must surely be a daunting one, if not the most daunting.

Despite all these uncertainties, we can draw comfort from the fact that the Malaysian government has, in the recent past, been pro-active. Malaysia was the first off the mark in introducing an off-budget stimulus package in March this year following indications that the slump in the global electronic demand has turned out to be longer than initially expected. Again they received top marks for being very quick to introduce additional budgetary stimulus of RM4.3 billion recently following the September 11 attacks on the US.

Without a doubt, the terrorist attacks on the US have set the expected recovery in Malaysia back a couple of quarters and reduce the momentum of an expected recovery next year as the US economy tetters at the brink of a recession. For this year, the Ministry of Finance (MOF) has estimated that economic growth will be between the range of 1 to 2 per cent. However, there are a number of downside risks that could bring actual growth down to the lower end of this range or maybe even lower. Firstly, presumably the MOF uses the International Monetary Fund (IMF) latest Economic Outlook Report released in October 2001 as the basis of their global economic outlook assumptions. But the IMF Report was finalised before the September 11 attacks, suggesting that the global economic conditions could well be more difficult than envisaged in the IMF latest estimates.

Secondly the MOF expects nominal export growth to fall by 10.6 per cent this year. For the first eight months of this year, the average growth in exports already showed a contraction of 7.7 per cent. Furthermore, the downward momentum clearly is picking up with August figures recording a high of 18 per cent. The figures for September, at the time of writing, are still not released yet. But looking at some of the numbers around the region for the month of September, there is a likelihood that the fall in Malaysia's exports in September could be significant enough to take us past the official full year forecast. Taiwan exports and Singapore's non-oil exports both fell by a staggering 42 per cent and 30 per cent respectively in September.

A similar story is seen in Malaysia's intermediate imports, a proxy for future output growth. The MOF expects a contraction of 11.4 per cent for the year. The performance for the past eight months already reported a contraction of 10 per cent with the latest reading recording a steep fall of 27 per cent.

The projected growth for next year is anybody's guess. But it is likely that a recovery, at the earliest, could happen in the third quarter and even then the momentum could well be somewhat muted.

Moving over to the broad objectives of the budget, there were two broad guideposts to the 2002 Budget. On one side is the need for an expansionary budget to cushion the economic slowdown. On the other side is the need for the government to keep spending within prudential limits. The immediate task therefore is to strike a delicate balance between the two. By capping the deficit at 5 per cent of nominal GDP in 2002, which is below the conventional yard stick of about 6 per cent, the government appears to be mindful of the rising fiscal deficit, making sure than the measures proposed to counter the current economic slowdown would not undermine the country's prospects in later years. Japan, buried under a mountain of debts, stands out as a clear illustration of what happens if a government spends too freely for too long. Also, holding back on some of the expenditure now would allow room for other smaller off-budget packages later if economic conditions deteriorate much further.

Even with total federal government debt having gone up to 42.2 per cent as a percent of GDP in 2001 from 36.9 per cent last year, Malaysia should have very little difficulty plugging the hole in its budget. Given its good credit standing, Malaysia can resort to foreign borrowing. Even that may not be necessary as the excessive liquidity situation prevailing in the domestic banking system should allow the government to tap funds locally without running the risk of crowding out private investment.

It is quite clear during the current economic slump that Malaysia has a structural problem – that is the over dependence on electronic exports. Electronic exports account for slightly more than half of total exports. In light of that, the adoption of an internal growth strategy by diversifying the sources of growth through trade and domestic industrial activities in order to reduce the reliance on the electronics sector appears to be a sensible course that should help improve economic resilience. Afterall, the reason why we have not suffered as much as Singapore is partly because of the relative resilience of our domestic industries.

Another major theme of the budget, with a hint of a political overtone, is the social development objective of ensuring equitable distribution of income between urban and rural areas. This, however, is long overdue, as the widening income disparities, especially among the bumiputras, have given rise to some grievances.

Apart from the old fashioned Keynesian pump priming, another big emphasis of the budget is to put more money into the consumers' pockets, hoping that they would spend. To encourage private consumption, measures such as a 1 to 2 percentage points reduction in personal income tax, the reduction or abolishment of import duties of selected consumer goods, a half-month bonus payment and a 10 per cent salary increase for civil servants were introduced. In addition, the tax on bonus in excess of two months was abolished while the chargeable income subject to the maximum tax rate was increased from more than 150 thousand ringgit to more than 250 thousand ringgit. On this last point, one wonders whether it would be more appropriate to instead raise the threshold tax brackets on the other side of the spectrum. After all, the lower income group often takes the biggest beating during an economic downturn.

There was also no announcement on whether the 2-percentage point reduction in EPF contribution due to expire in April next year would be extended for another year. If that is not extended and combined with the proposed 10 sen hike in the retail price of petrol and the lowering of threshold for the imposition of taxes on services, some of the effects of the measures to boost consumption spending could well be offset.

A big surprise and a disappointment to the business community was the announcement that there would not be a reduction in corporate income tax. Before the budget, businessmen, almost uni-vocally, not only wanted a reduction in corporate tax but also suggested that the government make a pre-announcement to cut taxes annually to a medium-term target of 25 per cent. The pre-announcement, they claimed, could encourage new incremental foreign direct investment and at the same time discourage those that are already here from relocating.

In our pursuit of an internal growth strategy, the budget, perhaps unintentionally, may appear to be a bit too inward looking with efforts to attract foreign direct investments seen having taken a backseat. Until the country has produced a sizeable number of local companies that could compete internationally, there should be no let-up in the pursuit of foreign investments despite the fact that the competition for funds are getting increasingly keen. China, with its first class labour force but third class wages is a big threat. Already they are diverting foreign investments away from ASEAN. Also India, another sleeping giant, is slowly opening up some sectors to foreign participation. And Singapore, whilst aggressively opening up its financial sector, has cut its corporate income tax to only 24.5 per cent, the lowest in ASEAN. Furthermore, the terrorist attacks have made international investors more risk-averse, suggesting that the competition for foreign funds could become even keener and that threatens to further slow the flow of capital into ASEAN. The bottom line is we cannot effort to lose out. Already, the latest competitiveness report showed that Malaysia's ranking has fallen.

Another sector that did not receive any incentive is the property sector, currently mired in a massive overhang of unsold units. The overhang basically reflects the gross mismatch between supply and demand. Unless prices adjust downwards to market clearing levels, there is a strong likelihood that the overhang problem would not be solved even with more incentives thrown in.

Apart from the above, it is difficult to understand why, in the face of falling oil prices, the government has raised the retail price of petrol by 10 sen. Whilst it is necessary to move away from subsidies to a more market-based pricing mechanism, the timing may not be appropriate.

On its overall impact on the economy, there is very little the budget could do to counter the impact of the slowdown given the size of the external sector (its like a 100 pound human fighting a 1000 pound gorilla) and with an economy firing only with one cylinder. Furthermore, the multiplier effect from fiscal expenditure tends to be lower during a business down-cycle than in an up-cycle. This is hardly surprising given that businesses and consumers (excluding the civil servants) are unlikely to spend in the face of weak sentiment due to bleak employment and income prospects. The best the budget could do is to ease some of the pain associated with the current slowdown.

Still, the budget is only one of the options in the government's range of economic arsenal to counter economic difficulties. It has to be complemented by other policy actions. With the threat of a recession looming, the government would have to look at all possible policy angles that could soften the recessionary blow.

On the monetary front, though interest rates are already very low, there is still room for lending rates to fall further given the relatively wide margin between the lending rate and the cost of funds. This should provide some breathing space for highly geared companies. But the room for manoeuvre is somewhat limited. On the currency front, there is little point in tinkering with the currency peg to gain competitiveness given the exceedingly weak external demand. What can be done is to encourage banks to extend more loans but even that would be difficult given the lack of quality borrowers.

Apart from oiling the government machinery by cutting down red tapes and bureaucracy to ensure the fast implementation of projects, a lot of public relation works needs to be carried out to clear misconceptions about Malaysia, especially after the September 11 attacks. While the Malaysian economy was brought to heel by financial contagion that started in Thailand in 1997 we have to be mindful, this time, of the threat of `religious' contagion. Incidence such as anti-American rally and threats against the Americans by extremist group in Indonesia, for example, could hurt foreign investors' perception of Malaysia. At moments like these, such factors could influence investment decisions far more than extending the reinvestment allowance or even a cut in corporate taxes. Foreign investors have to be constantly reminded that Malaysia is a peace loving, balanced and moderate Muslim country.

Overall, although we may not fully agree with all its aspects, the budget, we think, is responsible and prudent. With that, it is hoped that our long-term strength would give us the capacity in the short-term to ride over these turbulent times as best as we can.