

Looking Forward To A Better Year

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By Kevin Chew

The first half of the year 2003 has been another trying period for policymakers. The war in Iraq and the SARS (Severe Acute Respiratory Syndrome) outbreak had combined, threatening to slow the economy to a walk. However, with clever policy manoeuvring, the economy, once again, managed to escape miraculously. Unlike some other SARS afflicted countries, Malaysia posted a surprisingly strong growth of 4.5 per cent in the second quarter of 2003. This was nearly as strong as the 4.6 per cent reported in the previous quarter. No wonder, there were critics out there who were puzzled as to how the economy could have possibly escaped unscathed given the significance of the services sector, in terms of its contribution to real output. And the 'yo-yo like' adjustments in the government's industrial production figures then gave them more reasons to be sceptical.

But now, few can doubt that the economy's performance as well as its outlook has improved since the second quarter. The relatively more upbeat message was propagated by the preponderance of evidence and reports, both official or otherwise. The numerous quarterly surveys on key sectors of the domestic economy conducted by MIER have indicated that most businessmen and consumers are confident that economic conditions are now better than in the first half of the year. And Bank Negara's recent press release on the third quarter GDP numbers reported that the strong private sector response to the pro-active government measures, amid a low interest rate environment has strengthened the economy's growth momentum. This has allowed the economy to gain further momentum to expand by 5.1 per cent in the third quarter.

Further more, visitor arrivals have almost gone back to their pre-SARS levels. As a result, tourism and hotels sub-sectors, the hardest hit during the outbreak, are again looking busy following the sharp rise in occupancy rates and bookings for tour packages. Another bit of good news came from the financial front. Buoyed by an excess liquidity environment, local and, to a lesser extent, foreign funds have capitalised on Malaysia's recovery story by pushing the stock market up in excess of 20 per cent thus far. The wealth effect from financial price appreciation, in turn, has provided further oomph to consumption spending and fuel further the increase in demand for residential property, especially for mid to up market units.

More importantly, foreign direct investment (FDI) flows, as indicated by foreign investment applications in manufacturing projects, have been revived, indicating that Malaysia has not entirely lost its charm as an FDI destination. Foreign applications already reached RM10bn during the first three quarters of 2003, which is within touching distance of the RM11.7bn reported for the whole of 2002. Perversely, China's initial mishandling of the Sars outbreak could well be part of the reason for the recovery. Still, there could be more potential factors that could throw a wrench into the expectation of a further rise in FDI in the months ahead. Economic observers are waiting anxiously to see whether the foreign investment community, especially in the US, will heed the call of a leading and influential US based Jewish lobby group, Simon Wiesenthal Centre, to boycott tourism and investment in Malaysia, following the former Prime Minister's remarks on Jews in the OIC meeting in October.

Equally important, the improvement in the global economy has come at an opportune time. There are clearer indications of a broad based upturn in the G3 economies, And encouragingly, the global IT indicators have continued to improve. The US factory

activity, as indicated by the sharp surge in the manufacturing index tracked by the Institute of Supply Management (ISM), has raced ahead in November to reach its highest reading since December 1983.

Malaysia, because of its strong underlying fundamentals, has always been well positioned to benefit fully from a recovery in external demand. Therefore, it was indeed very puzzling this time when Malaysia exports, contrary to what was seen in the East Asian region, initially failed to show signs of life for three straight months during July to September.

This has prompted some to speculate about the possibility that Malaysia may be facing a serious 'hollowing out' problem in the manufacturing sector. In recent years, Malaysia has lost a number of multinational companies that had relocated their operations, partly or entirely, to China, Thailand or Vietnam. Also there were speculations that exporters might be parking their export proceeds overseas to circumvent exchange controls. The chief explanation for the weakness in export figures has turned out to be the under reporting caused by the changeover in the data processing system from the manual processing system to the Electronic Data Interchange system, an online network system to speed up cargo documentation and customs declaration that would reduce bureaucracy and the likelihood of bribery. Even then, the revised export figures, though higher, are not significant enough to dispel the earlier whispers of unease, as they are still well below the region's average.

So, given the current scenario, what is in store for the Malaysian economy in 2004? Can the recovery be sustained? The balance of evidence suggest that Malaysians could look forward to a better year in 2004 with economic growth of 6 per cent or thereabout. That is assuming that the current global recovery, especially in the US, is sustained over the next 12 months.

The pursuit of higher economic growth, however, will not be effortless. For sure, the economy will be without an important key driver that it has become so accustomed to in recent years - that is the stimulus from fiscal spending. Six years of expansionary fiscal policy, through annual budgets and well timed off-budget packages, to counter the adverse external conditions has left a gaping hole in the government's financial position. To be sure, running a deficit is not always a bad thing. In fact, as was the case for Malaysia, it was seen to be necessary and justifiable given that recessionary pressures threatened to derail the economy in recent years.

Though not at an unsustainable level yet, the government felt that with the economy recovering, it is now time to start trimming the deficit. The aim is to balance the book by the year 2006/07. The return to fiscal discipline is indeed prudent given that a failure to prevent a further significant accumulation of foreign debt could potentially impede the economy in the long term. After all, such deficits do indeed lurk behind many developing countries economic problems. In addition, a failure to rein in on the deficit despite the opportunity to do so could be interpreted as a sign of fiscal irresponsibility, raising Malaysia's macroeconomic risk premiums, which could eventually turn off foreign investment inflows.

As in the past, the government found very little scope to reduce operating expenditures. And with the recovery still in its early stage, the government cannot raise taxes. Hence, developing expenditure will have to bear the main brunt of the cutback with an RM8 billion reduction, or a sharp 21 per cent less than the previous year's allocation. This, together with higher revenues will bring the deficit down sharply to 3.3 per cent of nominal GDP for 2004 from 5.6 per cent in 2003, according to government report.

Without the stimulus from public spending, the private sector will have to work a lot harder to achieve the 5-6 per cent growth. The positive effects from past stimulus measures, the new as well as ongoing construction activity in the various expressways, railways as well as the renewed vigour in residential property construction will continue to provide significant spin offs to the domestic economy.

The task will surely be made a lot easier if the current recovery in global demand can be sustained. After all, domestic demand could not possibly sustain the recovery without a recovery in external demand. In this context, it is therefore encouraging to note that the current global recovery is broad based as it is not driven only by consumption spending but also aided by a recovery in investment spending, hinting that the grip from past investment excesses is now easing. This is very important as only an increase in investment spending can bring about a sustained recovery.

There is still room for the stock market to rise further in 2004. In all likelihood, the local stock market will continue to rise as the economy gathers further strength along a non-inflationary path. This will allow monetary policy to remain accommodative and justify holding down interest rate for most of 2004, even as the economy surges. Also, the Malaysian market, being a laggard, could benefit from rotational play as funds move out of markets that have out-performed.

The key fundamental factor driving the stock market will continue to be the excess liquidity prevailing in the system. About RM90 billion is currently locked out of the financial system through the central bank's aggressive mopping up exercise. Along the same vein as the old economic mantra stating that too much money chasing too few goods will cause prices to rise, too much money chasing too few financial goods will also cause financial asset prices to rise.

The new leadership has, no doubt, inherited a fundamentally strong economy. But much is still at stake. Although some significant progress has been carried out, better approaches and adjustments still need to be developed and adopted on some of the key policy issues. As the Asian financial crisis has showed, timely and accurate information is vital for investors to assess our economy. In light of the recent data confusion, it will be useful if any adjustments or changes in methodology in data collection be accompanied by a brief description of what have been done and whether similar adjustments have also been done on past time series to ensure consistency and comparability. This will also help economic analyst to gauge the pulse of the economy more accurately.

It is noteworthy that Prime Minister Dato Seri Abdullah Badawi has come out strongly to declare an all out war against corruption and emphasise the need for a more efficient civil service. These should go a long way to improve the government's delivery system. Instead of direct negotiations between the government and the appointed contender, there is a need to shift to a more transparent system that entirely promotes competitive bidding and meritocracy. That way, it will get rid of the layers of middlemen which, in the past, have contributed to gross inefficiency, shoddy work and wastage of government funds. This could surely help the economy to achieve more, even with much less government spending. Malaysia is working within a limited budget. Therefore, it will be crucial for policymakers to ensure that funds are spent prudently in order to ensure an effective allocation of resources. In this context, it is heartening to note that the government has rightfully decided to defer the financially unjustifiable double-tracking rail project.

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