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A crucial year for Malaysia

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THE year 2004 will undoubtedly be a crucial year for Malaysia and the region. Rising optimism resulting from the accelerating global economic momentum augurs well for the Malaysian economy.

Consumer confidence is surging, boosting domestic demand while export performance is speedily improving, at least according to the latest survey by the Malaysian Institute of Economic Research (MIER). At the same time, the MasterCard survey of consumer confidence by MasterCard reports that Malaysia ranks second after Thailand in the Asia Pacific region.

More importantly, 2004 will mark a new era of policies by Prime Minister Datuk Seri Abdullah Ahmad Badawi, following his predecessor Tun Dr Mahathir Mohamad's success in steering the economy to new heights. So far, the new administration has received an overwhelmingly positive response from financial markets following the appointment of Tan Sri Nor Mohamed Yakcop as Finance Minister II.

While an overall economic improvement is expected this year, the new administration realises that some critical issues will have to be addressed. Growth has to be maintained at respectable rates and exports would have to expand more vigorously. At the same time, Bank Negara Malaysia will have a difficult task steering interest-rate direction, especially with the prospect of higher borrowing costs in developed economies like the United States, United Kingdom and the euro region.

Another equally important task would be to address the budget deficit problem following pump-priming efforts undertaken to reflate the economy after the Asian financial crisis. The ringgit peg will also pose another challenge for the new administration, especially because of a swift decline in the value of the US dollar.

Growth Strategy

The new phrase in town is 'domestic demand', a sharp U-turn from the export-led strategy widely adopted by many Asian countries in the 1990s.

Most regional economies benefited from the expansion of global external trade during the past decade. No doubt about it, export-led growth was the darling strategy and was said to be the major catalyst for the Asian economic miracle. Growth rates accelerated by more than 7% per annum in most Southeast Asian countries in the 1990s and foreign direct investments (FDIs) were pouring into the region.

In 1998, however, the miracle stopped. Starting with the collapse of the Thai baht on July 2, 1997, the Southeast Asian economies were brought to their knees. Many ended up resorting to loans from the International Monetary Fund (IMF). Fortunately, Malaysia brushed off the conventional economic wisdom by resorting to capital control measures and pegging its currency against the US dollar.

After a series of Keynesian pump-priming efforts and low interest rates, the regional economies got back on their feet and by 2000, the Malaysian economy was once again roaring, growing at a torrid pace of 8.5%. A similar pattern was seen in other regional economies. While a general phase of recovery took place, many policy-makers suddenly shifted focus from traditional FDIs and external trade to enhancing domestic demand to bolster economic performance.

The dramatic shift was actually the result of volatile external demand following the economic bubble burst in the US in mid-2000. Adding to that were rising geopolitical risks that reinforced the idea that a sustainable

economy had to come from domestic-led consumption.

In Southeast Asia, Thailand's Prime Minister Thaksin Shinawatra emerged as an important individual who trumpeted the idea of the so-called 'dual track' economic strategy, which emphasised the enhancement of domestic demand activities. Private consumption became the main tool in stimulating economic activities through a low interest rate regime.

Similarly in Malaysia, pump-priming efforts and low interest rates became the core strategy to stimulate economic growth. Easy credit through the micro-credit scheme introduced in the latest stimulus package in 2003 has enabled many small businesses to expand and take advantage of the accelerating economy.

Other new growth areas were also identified to diversify the economy and reduce reliance on traditional electronic products. As a consequence, Malaysia's GDP growth for 2003 is expected to be about 5% compared with 4.1% in 2002 and 0.3% in 2001.

While Thaksin's policies are hailed as the new economic model for the region, the key question is whether such consumption-led growth can ensure the sustainability of economic growth in the next five to 10 years. This is where economists differ in their views.

A simple study was done to evaluate the above issue. Using Thailand as an example, our analysis seems to suggest that Thaksinomics has yet to prove its worthiness as a long-term policy. This is not to say it is a total failure. In fact, results so far have been so impressive as to prompt some Thaksin followers to claim this new economic philosophy to be comparable to Keynes' famous General Theory written in the 1930s.

What we are arguing, however, is the simple fact that the negative relationship between growth rates and change in unemployment still existed between 1983-2002. This can be seen from the red line in Chart 1. Therefore, there is nothing to indicate that this policy is a long-term solution for sustainable economic growth.

While this could be a difficult concept to grasp for those not familiar with macro analysis, the whole idea is quite simple. It goes like this: Economic growth can be obtained (after a recession) by adding more people to the labour market and by utilising idle machines. This would mean that growth is usually accompanied by a reduction in unemployment rate.

So as growth rises, the change in unemployment rate will be negative and vice versa. As long as this phenomenon clearly exists, economic expansion is simply a result of a reduction in excess capacity. Unfortunately, however, the unemployment rate cannot be driven down forever, meaning that this type of growth will not be sustainable.

The same phenomenon can be seen in the US economy in the 1980s. While some economists tend to argue that Reaganomics (President Ronald Reagan's economic policy) brought new ideas that bolstered the economy during that period, the relationship between growth and the change in jobless rates indicates otherwise.

The negative relationship was significant between the two variables (indicated by the tightly fit data around the so-called regression line - the red line). That means, no significant structural changes were seen in the economy in the 1980s, as shown in Chart 2a. This however changed in the 1990s when productivity growth suddenly jumped after 1995.

Therefore, what can really sustain the growth of an economy in the long term is actually a rise in productivity. This can be seen from what happened to the US economy in the 1990s.

When productivity becomes a major force in stimulating economic growth, GDP expansion need not be accompanied by a reduction in the unemployment rate - at least the negative relationship may not be that obvious anymore. Jobless rates can remain unchanged but output keeps expanding. This can be

seen in Chart 2b where the data is not so tightly fitted around the red regression line.

Therefore, there is no clear negative relationship between growth and the change in unemployment rates seen here.

So what are we saying here?

For one, consumption-led growth can provide a temporary buffer for our economy. In fact, this type of strategy can go on for several years. It is thus an excellent strategy for keeping the economy afloat while formulating a more structural change to achieve potent formulas for long-term sustainable growth through productivity enhancement. This is what Malaysia is currently doing.

Realising this, the Government is currently searching for new growth areas and new global markets for the country's products. The idea of relying on electronic exports is something of the past. More domestic demand can be created through the introduction of new products and services.

At the same time, external trade would have to expand beyond the traditional markets of the US and Europe. The new potential markets are now well known - China and India.

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