

BEHIND THE POLITICS, A PRESSING DEFICIT

Heavy deficit spending in the last six years of former Prime Minister Mahathir Mohamad's tenure has strained government cash flows and prompted his successor to sharply scale back spending, delay projects and try to raise fresh funds.

Since Abdullah Ahmad Badawi took over as prime minister at the end of October, his government has indefinitely postponed a 14.5 billion ringgit (\$3.8 billion) railway project, stalled work on a 1.2 billion ringgit bridge to Singapore, gone after wealthy tax dodgers and sold more than 9 billion ringgit in stock in listed companies.

The moves have been seen as Abdullah's attempt to weaken a legacy of patronage politics and distinguish himself from his famed predecessor. What's been overlooked so far is even more compelling: Abdullah is trying to stem the red ink resulting from years of deficit spending during the Mahathir era. Businessmen and government officials say the new approach is also a hedge against confusion over the precise amount of other liabilities—mostly off-balance-sheet financial obligations—the federal government could incur in indemnifying private-sector infrastructure projects such as highways, ports, bridges and public-housing works.

The prudence epitomizes the cautious approach taken by Abdullah in governing Malaysia, in contrast to the freewheeling ways of Mahathir. Bankers say that there was overspending during Mahathir's tenure, especially in its final years between 2001 and 2003. It took the government only those three years to spend 99% of its 110 billion ringgit five-year official development budget for 2001-05, known as the Eighth Malaysia Plan. Mahathir, in his last budget speech, added another 50 billion ringgit to development spending for 2004-05.

Some economic analysts say reduced spending will retard growth and crimp the construction sector, a key economic driver.

And because dishing out government contracts to influential businessmen has long been a cornerstone of Malaysia's political economy, some analysts warn there could be political repercussions from severe cutbacks.

But most economists say that the new emphasis on caution is a long-term positive when considering Malaysia's budget deficit, which is officially projected at 5.5% of GDP for 2003.

"A budget deficit of over 5% of gross domestic product isn't sustainable for most countries," says Chu Peng, an international credit-rating analyst with Standard & Poor's, which recently upgraded Malaysia's sovereign debt on expectations of an improving fiscal balance. "The Malaysian budget deficit stands out, it's very significant in the region." In Southeast Asia, only the chronically troubled Philippines' deficit exceeds that of Kuala Lumpur.

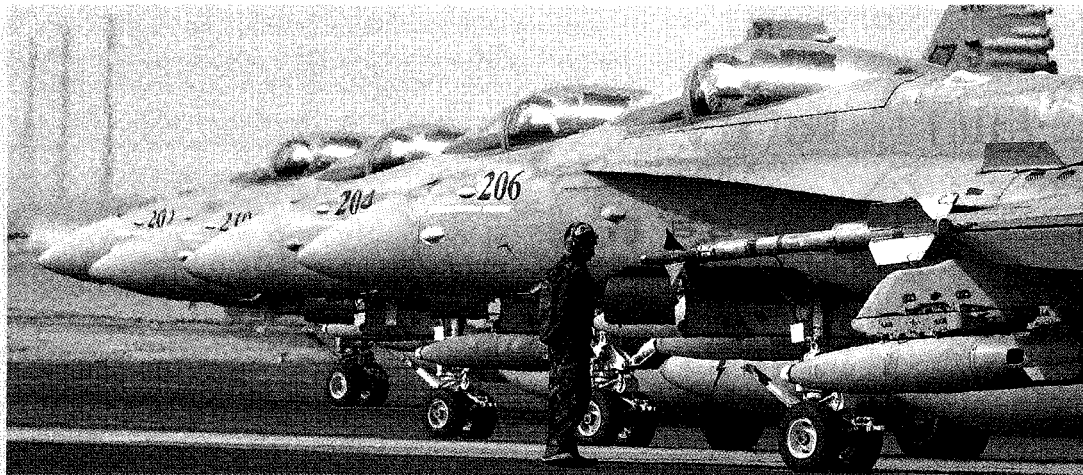
Government officials say that Abdullah was shocked at what he called "a sea of red ink" after he also assumed the Finance Ministry portfolio from Mahathir last year.

The new premier has promised to balance the books, but officials say it will be done gradually, on a declining-trend basis, rather than sharp cuts that could provoke a political backlash from businessman aligned to the ruling party.

Revenue collection has been emphasized. In December, for example, the Ministry of Finance sold down its shareholdings in four state-owned companies—utilities Tenaga Nasional and Telekom Malaysia, Bintulu Port and banking group Commerce Asset Holdings—for an estimated 9.2 billion ringgit. The stakes were sold to other state institutions, including oil corporation Petronas and the Employees Provident Fund, a state pension plan.

The move is also aimed at improving the companies' liquidity. Foreign fund managers have long complained that big share blocks in Telekom and Tenaga, over 70% owned by government, are hard to obtain. "The sales will help our cash flows," says a

Politics isn't the only motive behind Abdullah's big cutbacks: The budget matters, too



HOLDING PATTERN: Abdullah has deferred the purchase of 18 F/A-18 jets

highly placed government official, "but they will also increase liquidity as Petronas and the EPF are free to place the shares out."

To boost the coffers further, Malaysia's tax department has increased collections. This occurred most spectacularly in January when it raided 10 of the biggest construction companies for alleged tax evasion. The raids are expected to net the government hundreds of millions in back taxes. "I'd say it was without fear or favour," says a businessman with grudging respect. "Some of these boys are really big."

Military purchases have been deferred too. Among them: 18 United States-made F/A-18 fighter/attack aircraft, first agreed to in talks between Mahathir and President George W. Bush in 2002. Other deferrals could include two to four Russian heavy-lift helicopters for the air force and at least two British frigates for the navy. "I have been told that it will take between 12 and 18 months to bring all these purchases up for discussion again," says a businessman familiar with the deals.

Unease remains over the exact exposure the government could face over indemnities it gave private-sector projects. These range from highways and transport systems to public-

housing projects given to the private sector and guaranteed by the federal government. The government has stepped in before: After the Asian financial crisis, for example, it spent more than 70 billion ringgit supporting banks and nationalizing infrastructure works.

Nor do chronic deficits provide comfort during downturns. In a recent evaluation of worst-case scenarios such as another financial crisis, Standard & Poor's estimated that Malaysia could face a potential cost of 50%-79% of 2003's GDP in propping up its financial system and rescuing public enterprises. Only China (74%-111% of GDP) fared worse. In contrast, Singapore, with its budget surpluses, would need to spend only 11%-26% of GDP in such a crisis.

Predicting the worst may be an intellectual exercise, but Abdullah's new prudence is intended to bring Malaysia back to the comfort zone. "This is not to say that the government thinks more projects will fail," says a banker close to the government. "It's just to get a handle on things."

(For more on the Malaysian economy, see *Economic Monitor*, page 42.)

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