



Will It Be a Good Year?

It's time to peer into the crystal ball again. What do we see for the Malaysian economy in 2007?

MANY HAVE PROBABLY READ ECONOMISTS' PREDICTIONS FOR THE global and Malaysian economy for this year – what the macro picture might look like, its implications on stock and bond markets and so forth. Their forecasts vary significantly, and that can be very confusing for the man-in-the-street. Even economists from well-established international brokerage houses differ markedly in their forecasts.

An economist from Goldman Sachs Group Inc, for instance, predicts that the US Federal Reserve Bank (Fed) would lower its key interest rate – the federal funds rate (FFR) – to 4.5% due to the bleak outlook for consumer sentiment. Another economist from Barclays Capital foresees the FFR being raised three times this year to 6%. There we go. Who do we believe?

I do not wish to add to the confusion, although I would have to casually throw in my own numbers throughout this article. What I think is more important are the different issues that might affect the Malaysian economy in 2007.

To start with, the Ministry of Finance and Bank Negara Malaysia (BNM) are confident that the economy will cruise along nicely as sustainable consumer spending and a revival of construction activities will offset the moderation in external demand. This story line jives well with the news flow from the developed economies. The US is experiencing a 'soft patch' but its economy is not expected to tumble in 2007 as consumers are still very much alive and will likely drive up private consumption.

Japan is undergoing the longest expansion post-World War II and growth in the Euro region countries is gaining momentum. So Malaysia's external trade may not be significantly affected after all.

I agree with the above story line, although my numbers are not as robust as the government's projections. Barring unforeseen circumstances, Malaysia will still be able to grow within its long-term trend of 5%-6% in the next few years. The current so-called incremental capital-output ratio (dubbed ICOR) still indicates a decent potential growth despite slower expansion in private investment. ICOR is simply the ratio of investment to the country's output (measured by the Gross Domestic Product or GDP). The higher the ratio, the less efficient the investment is.

Fiscal pump-priming has already taken place with the implementation of projects under the Ninth Malaysia Plan (9MP) and monetary policy remains accommodative. So what are the relevant issues in 2007?

In my opinion, there are a few. First and foremost is consumer spending. The consumer has been an important pillar in the Malaysian economy in the past several years. In fact, since the Asian Financial Crisis of 1997/98, most Asian economies (including Malaysia's) have adopted a consumer-led growth policy after investments collapsed in 1998.

Monetary policy became extra accommodative as central banks provided great incentives to consumers to boost private consumption. Low interest rates were used to lure consumers to splurge on conspicuous consumption. It was a worthwhile strategy and Asian economies recovered significantly in the years following the crisis. Thailand's economic policy, which focused on efforts to strengthen consumer spending, dubbed Thaksinomics, became a model for many Asian economies.

Except for second-quarter 2005, the growth of Malaysia's consumer spending has accelerated by double-digit rates between second-quarter 2004 and third-quarter 2005. In the past one year, however, consumers became less enthusiastic as the impact of inflation started to bite. Its growth moderated to 6.8% in the second quarter of 2006.

Rising pump prices of petrol from RM1.52 per litre in May 2005 to RM1.92 per litre in May 2006 led to a more cautious attitude among consumers. Higher electricity rates and water tariffs magnified consumers' concern over the rising cost of living and the recent announcement of higher toll rates may further curb spending.

The consumer price index may look benign, possibly around 3% or even lower, but the impact on consumers should not be underestimated. So, weaker-than-expected consumer spending may be one factor that pulls growth down in 2007.

That leads to a related problem of consumer debt. As financial intermediaries aggressively tried to expand their share of the consumer segment, the number of bad debt began to rise. Faced with higher inflation and borrowing cost, financially over-stretched

consumers are starting to face difficulties in paying their debts on time.

Not surprising, recent estimates indicate that the consumer debt-to-GDP ratio has escalated to about 60% at the end of last year from 44% in 1998. The worry is that once banks start to feel the pinch of high bad debt, they will start to pull the plug off the consumer segment, causing a sharp decline in private consumption. That has been happening to South Korea in the past four years, when the consumer debt surpassed the 70% ratio of GDP (see chart).

The third issue is the impact of the slowdown in the US. The Fed is currently holding the FFR steady at 5.25% as policy makers try to assess the impact of the housing slump. The latest statement from the central bank indicates a mixed economic performance and describes the year-long housing slump as 'substantial'.

At the same time, inflation is still a major threat as the core personal consumption expenditure (PCE) – the Fed's favourite gauge for inflation – is well above its comfort zone of 1%-2%.

2005. While the ringgit's appreciation was initially slower than that of the Chinese renmimbi, the recent upsurge in the Malaysian equity market has led to a sharp strengthening of the local currency.

Over the following months, the ringgit is expected to strengthen further due to several reasons. First, the renmimbi is anticipated to rise further because of China's large trade surplus, especially with the US. Having a huge trade surplus would mean more political pressure from the US to let the renmimbi strengthen further.

The second reason is that Malaysia's macro fundamentals are still very sound and the ringgit's value is still below its parity level, at least from the prospect of real effective exchange rate (REER). With the prospect of further strengthening of the ringgit, exports will be adversely affected in 2007.

Fifth is the budget deficit. The ratio of fiscal deficit to GDP makes Malaysia stand out among the countries in this region. Just like other countries in Southeast Asia, the large fiscal deficit originated from pump-priming efforts during the Asian Financial Crisis, which were meant to revive economic growth at a time when the private sector was extremely weak.

As for Malaysia, its fiscal deficit peaked in 2000 when its ratio to GDP hit 5.7%. Since then, the Government has taken rigorous steps to overcome the problem. As for the next few years, it is projecting a fiscal deficit of around 3.4% of GDP, still huge compared to that of neighbouring countries, which have managed to reduce them to almost zero.

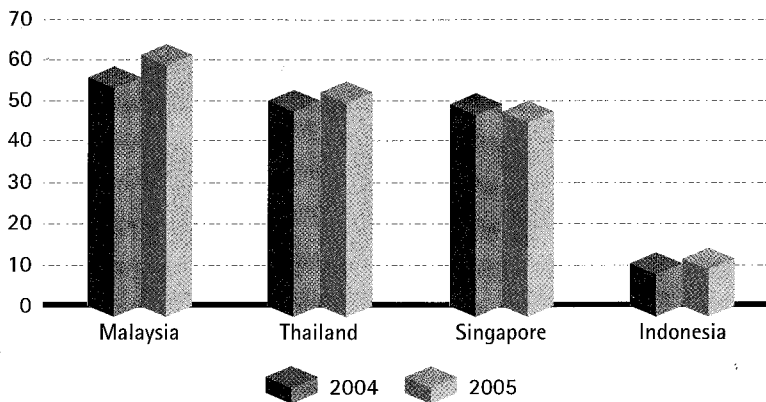
The problem is that with a strong focus on reviving domestic private investment, pump-priming efforts will eventually lead to more deficit in the near future. If these efforts are successful in jolting the growth rate, then fiscal deficit as a ratio of GDP will not rise. However, a mediocre growth rate would only mean deterioration in the deficit ratio, which would

eventually have a negative effect on Malaysia's international rating.

In short, with global uncertainty with regard to external demand, Malaysia would have to depend largely on its domestic economy. As for the next few years, the Government has already laid its plans to rejuvenate the economy through fiscal pump-priming, especially in the construction sector. With a high multiplier effect, these efforts will likely be able to offset the softness of the export sector.

There are however crucial issues that economists will closely watch in 2007 – the strength of consumer spending, the consumer debt level, inflation, the ringgit's movement, and the country's fiscal position. **mb**

Consumer Debt As a Percentage of GDP



Source: CEIC, BNM

Recent rhetoric suggests that Fed's policy makers are more concerned about rising inflation than slowing economic growth. It would come as a big surprise to the financial market if the Fed decides to resume its rate hike series as traders and investors are banking on a rate cut this year.

Should that happen, economic growth will take another big hit and trading partners like Malaysia will have to endure slower export growth in 2007. It should be noted that while regional trading partners may be able to cushion the blow, most of these countries also depend on the US as the final destination for their products and services. Therefore, they may not be able to escape the downturn in trade should it happen this year.

The fourth issue is the value of the ringgit. At the time of writing, the currency had appreciated by 6.8% from its pegged level in July

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