



Slowing the Pump

Is the Malaysian Government committed to balancing the budget? Looking at the Ninth Malaysia Plan it seems to be, but not to an extent that would affect growth.

It was such a nice surprise to flip through the various reports on the Malaysian Government's recently announced Ninth Malaysia Plan (9MP). While I had expected some 'goodies' for the *rakyat* in this five-year plan, I was more excited by the way policy-makers are looking at the issue of fiscal deficit.

Yes, the country is trimming the budget deficit – but at its own pace and not at the speed some international institutions normally recommend. According to the 9MP, the budget deficit will be reduced gradually to 3.4% of gross domestic product (GDP) from 4.8% in the previous five-year plan.

To be honest, colleagues often snub me when I talk about the issue of budget deficit. Some raise their eyebrows when they hear me criticising those who are gung-ho about fiscal discipline.

No, no, don't get me wrong. I don't believe in spending sprees the way the Reagan Administration did in the 1980s in the United States. Those who remember that period would understand what I mean.

When economic issues were discussed in the presidential debate in 1984 between Ronald Reagan and Walter Mondale, it was mainly on the budget deficit. In the 1988 presidential debate, the same topic was addressed by Michael Dukakis who tried to challenge George H W Bush on the 'Voodoo Economics' implemented under the Reagan Administration.

Overspending is indeed an evil thing to do in an economy, but so is an overly strict rule on budget-balancing.

International institutions, however, are so engrossed about government budgetary positions. Countries in the Eurozone, for example, are asked to keep their budget deficits below 3% of their GDP. Latin American countries were asked to slash their government budgets during their crisis in the 1980s.

And remember the Asian Financial Crisis? The standard prescription was to cut the budget deficit and to keep interest rates high. Those countries that subscribed to this were mired in deep recession. Those that went along with the Keynesian (followers of John

Maynard Keynes) prescription of pursuing deficit policies saw their economies being buffered, although government budgetary positions worsened.

First, let's take a look at the reasons Keynesians oppose budget-balancing during a recession. As we are aware, during an economic boom, income rises, pushing up net tax collections. That can lead to a government budget surplus.

During such times, there is no reason for the government to increase spending because economic activity is already robust. An expansion in economic activity will therefore lead to a more restrictive fiscal policy, which will eventually dampen the overall expansion.

The opposite would happen during a recession. Hence, we can see that changes in the government budget work as an automatic stabiliser for economic activity.

What would happen if the government insisted on balancing its budget during bad times? During a recession, for instance, government revenue is already falling due to smaller receipts from taxpayers. Raising taxes or cutting expenditure at times like this would only magnify the hardship of the people. At the same time, jobs would be harder to get due to the reduction in government spending.

Such a situation was experienced during US President Herbert Hoover's administration in the early 1930s.

If that is the case, why are some economists so supportive of deficit reduction? Part of the answer, I think, is to bring back 'confidence' to an economy by ensuring the government does not overspend. At the same, scaling back the deficit is supposed to bring down interest rates, which in the long-term would stimulate an economy. An example normally cited is the experience of the Clinton Administration.

When Clinton took office in the early 1990s, he was persuaded to make deficit reduction his prime duty although job creation was his major election promise. This was because the deficit had bloated, thanks to 12 years of the Reagan-Bush Senior administrations, which slashed taxes and splurged on the Star Wars defence

programme.

But that was supposed to revitalise the economy and increase revenues, at least according to economist Arthur Laffer, on which 'Reaganomics' was based. However, as the years went by, it was obvious the 'self-paying' results promised by Reaganomics did not materialise. In the end, Clinton had to do the cleaning job.

Clinton proposed cutting expenditure as well as raising taxes to bring the deficit under control. As the economy was still fragile following a recession in 1991, many thought the policy would backfire because a deficit reduction during such times would hinder further recovery.

But Clinton was lucky because things turned out to be different during that time. Interest rates fell as the banking sector was strengthened after the introduction of new regulations following the savings and loans debacle. The banks' balance sheets improved and lending grew. That strengthened the economy.

It is important to note that Clinton's success does not mean the Keynesian prescription is outdated. One reason the administration succeeded was the rising confidence of that time about the overall economy as millions of jobs were created. I agree with the Nobel Prize-winning economist, Joseph Stiglitz, that the recapitalisation of banks to some extent revived investors' and consumers' confidence – the confidence that was shattered by the overspending in the 1980s, especially on the Star Wars programme.

It was not the deficit reduction per se that revitalised the US economy in the 1990s. In fact, there is no clear-cut evidence to show that fiscal deficits bring recovery or forestall economic growth.

One thing for sure is that, in analysing budget deficits, one has to differentiate between *cyclical* and *structural* deficits. The cyclical deficit is the portion of deficit that results from an economy that is running below its potential rate.

Keynesians view a cyclical deficit as desirable because during recession, higher public spending is needed to offset the decline in private consumption and investment.

A structural deficit, on the other hand, is the portion that would exist even when the economy is above its potential level. In other words, structural deficit is a result of policy-makers' decisions about spending, tax rates, transfer programmes, etc.

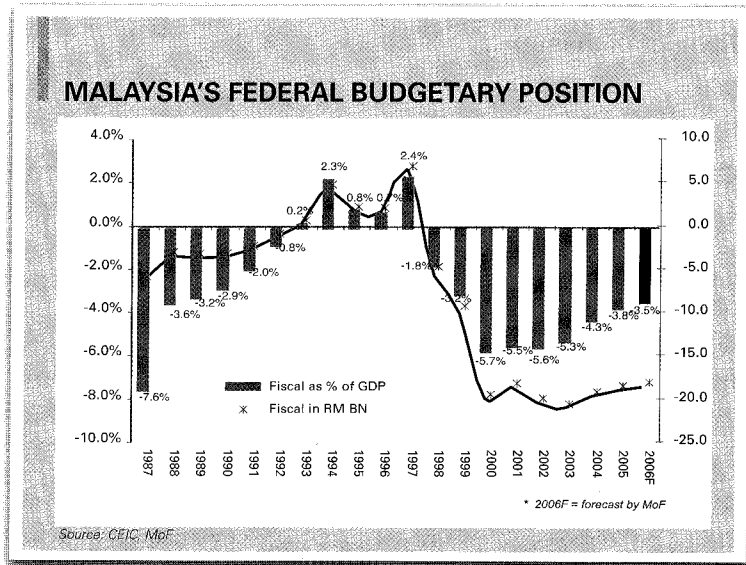
According to a majority of economists, a cyclical deficit is more desirable than a structural deficit, the latter being a major problem. Structural deficit means mismanagement of spending that could turn a country into a banana republic. Good examples can be seen in Latin America.

The US however is an exception, as it had been able to

roll its deficit from 1969 to 1997 without any economic collapse. That's mainly due to her ability to attract massive capital flows from other countries to fill the budget gap.

What about a country like Malaysia? Malaysia's long-term growth is currently estimated to be in the vicinity of 6%, based on estimates using the incremental capital-output ratio (a ratio that indicates how much investment is needed to generate an additional percentage of growth for an economy).


Since the recovery from the Asian Financial Crisis, Malaysia has been able to grow above 6% in three out of seven years – 1999, 2000 and 2004. In other words,



Malaysia is still fundamentally strong but is growing at a pace slightly lower than its long-term potential. At the same time, geopolitical uncertainties are still causing higher volatility in global trade.

Given such conditions, it was not surprising to see the Malaysian Government coming up with stimulus packages in the past few years to cushion the impact of a slowdown in external trade. That has led to a deficit in the federal government budget.

Looking from this perspective, one can say that the budget gap is not structural because the economy has not been consistently running above its potential level. In other words, the current conditions justify the country running a budget deficit.

Reducing the budget gap would be an ideal policy but not at a pace that would jeopardise growth prospects. This is what the government intends to do, at least according to the 9MP. 

The writer is head of research at Alliance Merchant Bank