



## ALARM BELLS OVER DEFICITS

**Malaysia's budget deficit continues into 2009. How will this affect Malaysia's sovereign rating outlook?**

IT IS NO DOUBT AN EXPANSIONARY BUDGET. Budget 2009 unveiled by Prime Minister Datuk Seri Abdullah Ahmad Badawi provides goodies for the man-in-the-street in view of the rising cost of living. But it will cost the government RM208 billion, up from the revised estimate of RM198 billion budgeted for 2008.

And as expected, this expansionary budget will leave a hole in the government's coffers – equivalent to 3.6% of the Gross National Product (GDP) for 2009, after an estimated deficit of 4.8% of GDP in 2008.

Much of the increase in this year's budget deficit is attributed to the rising amount of subsidy the government has had to bear as a result of escalating oil and commodity prices. Even after reducing the subsidy for fuel sharply in June, the government's financing position continued to come under pressure because of the rebates it gave back to the *rakyat*.

On top of that, the rising cost of building materials has affected the construction costs of several government projects.

So now, the warning bells are ringing on Malaysia's fiscal deficit. Many have begun to scrutinise the country's rating outlook, fearing that it may be downgraded by the international rating agencies. Moody's, for instance, was reported to have indicated that the budget deficit was a crucial element in their rating equation and that it wished

to see Malaysia lower its budget gap in the near future. Similarly, Standard & Poor's lowered Malaysia's sovereign rating outlook from 'positive' to 'stable' in May following the general election in March.

No doubt, a budget deficit matters in evaluating sovereign rating. And for Malaysia, its fiscal deficit level has been a key macroeconomic variable scrutinised by foreign investors in the past few years. This is due to the fact that Malaysia's deficit is among the highest in the region. In addition, the deficit has persisted since the Asian Financial Crisis in 1998.

Although there could be some pressure on Malaysia's sovereign rating outlook, the actual rating may not actually be affected in the immediate term for a few reasons.

First, a budget deficit is only one of the variables used in evaluating sovereign rating. Other variables like the government debt level, current account balance, gross external reserves, and growth prospects are also considered, and they still look favourable at this juncture.

Take, for instance, the government debt level. Its proportion of GDP has been steadily declining since the mid-1980s. From our estimate, the debt level has shrunk to about 41.6% of GDP in

2007 from as high as 98% in 1986. The level is estimated to further decline to about 40%-41% in 2008 and 2009.

This is a pale comparison with Japan whose national

debt level as a percentage of GDP stands at about 195%.

The proportion of the government's external debt also matters. In general, the more the external debt as a percentage of total debt, the less favourable the country is, from a rating perspective. In this regard, it is fortunate that Malaysia's external debt level is relatively low compared with other countries – 7% in 2007.

Malaysia's current account on its balance of payments has also remained in huge surplus over the past several years. This has been the result of strong export growth in commodity and commodity-related products despite some softening of demand for electronic products.

In 2007, for instance, Malaysia managed to post a record high current account surplus of RM100 billion, equivalent to 16% of Gross National Product (GNP). In 2008, although exports are likely to be affected by slower external demand, Malaysia's current account position is expected to remain favourable due to strong commodity prices.

Malaysia's gross external reserves have also continued to increase following the favourable current and financial accounts. For example, net inflows of foreign direct investment (FDI) rose to RM29 billion in 2007 from RM22 billion in 2006. Prior to that, the average amount of FDI was around RM11 billion per annum in the 2001-2005 period.

As a result, gross external reserves have increased to RM400 billion as at end-August 2008, from RM362 billion in January.

Another important consideration is Malaysia's growth prospects. A country with stable growth outlook is favoured by rating agencies because growth in general will determine the amount of revenue collected by the government. High and stable growth would generally mean an increased likelihood of the government paying its debt.

A good example is Malaysia's revenue collection, which grew by a robust 16% and 13% in 2006 and 2007

respectively, following high economic growth of 5.8% and 6.3% during those years. As for 2008, the federal government's revenue is still anticipated to expand by a strong 15.5% as economic growth is expected to sustain at around 5.7% this year.

A final point is the budget deficit itself. Although it is generally seen as a bad thing, economists know that a deficit per se is not really the problem. A budget deficit only represents the gap between revenue and expenditure. What really matters is the way the deficit is being financed.

The fear of budget deficits comes from the fact that some countries finance their deficit through money creation, which naturally leads to hyperinflation. This

can be seen from the experience of some Latin American countries, which went through hyperinflationary periods that led to massive capital flights.

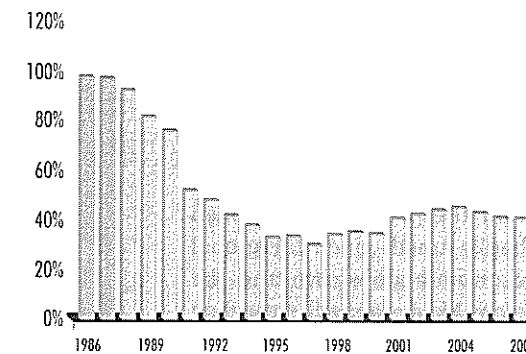
Such incidents can be avoided if the budget deficit is financed through domestic sources. In such a situation, the government normally issue bonds to the public and uses the proceeds to finance the deficit. In Malaysia, the

government normally issues Malaysian Government Securities (MGS) for this purpose. And as the deficit is normally financed through domestic sources, there is less upward pressure on the external debt.

Perhaps it is worth noting that Malaysia used to experience much bigger budget deficits in the early 1980s. In the early 1980s, for instance, the deficit as a ratio of GDP was about 15%. Similarly, in post-recession 1986, it stood at 10.3% of GDP.

Only since then was the deficit gradually reduced and a fiscal surplus achieved in 1993. After the Asian Financial Crisis in 1998, the deficit rose again to as high as 5.5% of GDP before sliding back to 3.2% in 2007. ■

**OUTSTANDING GOVERNMENT DEBT AS % OF GDP**



SOURCE: CEIC

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