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Ruang Pandangan/*Opinion Column*

Return of Depression Economics and Keynesian Prescription

GAN KHUAN POH

The Asian financial crisis has brought along in its wake the problems that characterised much of the world economy in the 1930s, the period of the Great Depression. According to Paul Krugman depression economics "essentially means that for the first time in two generations, failures on the demand side of the economy, insufficient private spending to make use of the available productive capacity, have become the clear and present limitation on prosperity for a large part of the world". Japan, Mexico, Russia, Thailand, Indonesia, Korea, Brazil Argentina, Turkey and Malaysia have experienced a recession that undo years of economic progress, and finds that the conventional policy responses only make things worse. Therefore, the question of how to keep demand sufficient to make use of the economy's capacity has emerged as critical. As we know Japan is finding that conventional monetary and fiscal policies are not adequate. What worries economists is that how sure is it that other economies, like Malaysia, would face a similar predicament? Recent developments in the world, particularly the geopolitical situation in the Middle East and the spectre of the health problem in the Asian region and the potential double dip economic recession in the USA have cast greater uncertainties and increased the potential risk that this malaise will spread. However, of greater concern is that the subtle risks to economic progress remain because generally free markets are unlikely to survive in a world where insufficient demand continues to be present. Concerns have been further raised on the efficacy of fiscal and monetary policies where Japan's series of fiscal stimulus packages have failed to spur spending to keep the economy's workers and factories employed. In addition, the US Federal Reserves' successive interest rate cuts over time does not seem to reverse the economic downtrend into recession and currently the possibility of another recession.

Malaysia's long-term strategy that is enunciated is on "endogenous driven demand" for growth; that is, domestic demand and sources of growth to make the economy resilient. Being a small and open economy that depends heavily on world trade it is more difficult to insulate the economy from exogenous influences or shocks.

EFFICACY OF FISCAL POLICY

Among the many reasons identified for the high growth of East Asian economies, including Malaysia, are the high savings and investment rates, export orientation and high export growth. These two factors are significant components of aggregate demand. Private investment was the major contributor to domestic demand compared to government spending. However, recently private investment has not fully recovered to pre-crisis levels. Fortunately, national savings is still high at about a third of GNP. The task is to mobilise these savings to productive sectors of the economy. Government spending can affect only a limited number of sectors of the economy such as construction, building materials industries, services but the scope of private investments is wider. The banks should be encouraged to increase lending rather than be risk averse by even turning away depositors. Public investment should not be constrained by prudence only in limiting the budget deficit to only five percent of GDP. To sustain long-run growth a larger public spending programme is badly needed when private investment and FDI inflows are not performing to expectations. The increase in budget deficit should be tackled on raising public revenues and later recovery to sustained high growth. Perhaps with the current low inflation environment and potential deflationary pressures a broader based tax structure in the form of consumption based Value-Added Tax (VAT) may be appropriate at this time. Its implementation will provide the Government with large revenue potential and avoid the budget constraint. There will be greater fiscal policy flexibility for the Government. This is more important now because of the limited scope for monetary policy in the presence of a very low interest rate and fixed exchange rate regime.

CHOICE OF INSTRUMENTS IN FISCAL STIMULUS

A budget deficit strategy to provide a fiscal stimulus can be effected either through increasing government or public sector investment or expenditure, or tax cuts. The former approach leads to a public-sector-led approach that reminds us of the active role of the public sector in the 1960s and 1970s with the rapid growth of the public sector and the proliferation of public enterprises and statutory bodies. The accompanying inefficiencies have motivated the Government to adopt a private-sector-led growth strategy and the pursuit of the accelerated privatisation policy where the private sector even undertook activities that were previously in the sole public sector domain.

The Government should not revert to full-scale public sector intervention but rather a very selective intervention to rekindle the private sector and continue to re-establish their role in a market-based system to come out of the current economic slowdown and sustain rapid economic growth to achieve the long-term development goals. On the other hand, tax cuts will release more resources for individuals and corporates for increased private investment, consumption or savings. This will promote allocative efficiency through the private sector as they are more sensitive to market forces and incentives to make the correct decisions.

Tax cuts should be geared towards encouraging aggregate domestic demand, particularly investment since this is the variable that suffered the most significant decline. Income and corporate taxes should be further reduced to spur private investment as well as remain competitive since the whole Asian region is inflicted with the financial crisis.

The tax rate should be gradually reduced progressively from the current 28 percent to about 18 percent in a number of years to be announced in the next budget. Since income earned in 1999 was to be exempted from income tax and in 1998 there was a large 34 percent drop in indirect tax collection due to significantly lower export, import, excise duties and sales tax collected, it is timely that a broad-based Sales and Service Tax (SST) or Value-Added Tax (VAT) be implemented to provide a good tax base for future increases in tax revenue.

Extensive studies on the implementation of the SST or VAT have been carried out and the tax is ready for implementation. The administrative machinery is ready and a quick decision will help to strengthen the process of tax reform to revive the economy through a market-based private sector led growth strategy that is business friendly as enunciated by the Government. This change will also revive investor's confidence and attract long-term foreign direct investment into the country.

MONETARY POLICY

In spite of the prominence given to monetary policy in the developing country setting, the transmission mechanism for monetary policy in a typical developing country has not been studied extensively, and consequently is not well understood. In developing countries, the structure of financial markets makes the operation of such a mechanism much more problematic. In the first place the menu of assets available to private agents is limited. Organised securities markets in which the central bank can conduct open market operations simply do not exist. Capital controls and prohibitions on the holding of foreign exchange limit the extent to which domestic residents may hold foreign assets. Finally, even in the case of those assets and liabilities available to individuals such as demand or fixed deposits and bank credit, official restrictions typically determine the interest rates paid and charged by financial institutions. The connection between the actions of the monetary authorities and the state of aggregate demand in such an environment is not obvious.

With current interest rates at a low level the scope of interest rate reduction as a policy instrument is restricted. With a pegged exchange rate, this policy instrument is not available to the central bank. The banking system is not too keen in expanding loans because of the levels of non-performing loans and as such there is ample liquidity in the market and the central bank has to mop up excess liquidity. This implies that increasing money supply through high-powered money is also limited. These indicate that the opportunities for using monetary policy instruments are rather restricted. The burden on fiscal policy to stimulate aggregate demand becomes more crucial and critical.

Dato' Gan Khuan Poh, PhD.
Senior Fellow, IKMAS
President, Malaysian Economic Association