Fiscal and monetary policy in Malaysia
Juggling economic imperatives and political reality

Xiaoye She

Since its independence, Malaysia has achieved rapid economic growth and significant poverty reduction, while keeping a relatively successful record of curbing inflation in comparison to other developing countries. Fiscal and monetary policy play major roles in guiding investment and spending behaviour to meet development and stabilisation goals in both the public and private sectors. This chapter provides an overview of fiscal and monetary policy in Malaysia, with attention to institutional foundations, the role of economic and political determinants in policy formulation and implementation, as well as interrelations among crises, economic restructuring and policy reforms. While political influence cannot be ignored in either policy area, recognition of the unsustainability of fiscal deficits as well as continued commitment to a balanced-risk approach in central banking may serve as important first steps in reorienting macroeconomic policies toward supporting private sector development and structural reforms.

Fiscal policy in Malaysia: institutions, history and the issue of fiscal deficits

Fiscal policy in Malaysia is designed to serve both stabilisation and development goals in meeting key objectives such as growth, equity, macroeconomic stability, reform and restructuring, as well as pursuing sectorial and regional development. The federal constitution provides the fundamental institutional structure for fiscal policy in Malaysia, as it grants the federal government revenue-raising power, via most important taxes, and the power to expend operating and development allocations. State and local governments are responsible for providing essential services, however; intergovernmental transfers and loans from the federal government supplement their relatively small and inelastic revenue base. Public finance accounts are divided into operating and development accounts, with the size of the budget for each determined by revenues and the government’s capacity to raise non-inflationary financing, respectively (IMF 1999). Various statutory bodies and non-financial public enterprises (NFPEs) share these operating and development expenditures in pursuing government objectives (IMF 1999).

Within the federal government, the Economic Planning Unit (EPU) under the Prime Minister’s Office performs the most important role in formulating and implementing...
development policies that directly impact upon fiscal policy, including drafting five-year Malaysia Plans. The ministry of finance (MOF) serves as the main centre for drafting, implementing and executing year-to-year budget plans, upon consultation with EPU and other federal ministries (IMF 1999; Hassan et al. 2012). The longer time horizon of Malaysia Plans complements budget plans in spelling out major policy directions and changes, as well as detailing new tax proposals and yearly expenditures.

Adherence to the principle of fiscal conservatism inspires tight budgetary control over operating expenditures, which are required to not exceed current revenues (Meesook 2001). This commitment has allowed the Malaysian government to maintain a current surplus, defined as current revenues less operating expenditures, in most years since 1970. In addition, the majority of borrowings used to finance development expenditures come from non-inflationary domestic sources, with explicit debt ceilings specified by the External Loan Act 1963 and other legislation. Nonetheless, fiscal discretion exists and contributes to a persistent overall fiscal deficit, reflected mostly in development expenditures and off-budget activities. Figure 12.1 presents a synopsis of the government’s overall financial position, revealing a fiscal deficit in most years except the brief period of 1993–97.

New Economic Policy and thereafter: the role of fiscal policy
As Doraisami (2011: 9) argues, fiscal policy in Malaysia has been intimately linked to the New Economic Policy (NEP) since its commencement in 1970. The pre-NEP era, 1956–70, was marked by import-substitution industrialisation (ISI) and a relatively laissez-faire approach towards the domestic private sector, which failed to promote significant economic development (Hassan et al. 2012; Ritchie 2004). While the government promoted ISI through tax exemptions under the Pioneer Industries Ordinance 1958, state intervention was much less pervasive and lacked a significant ethnic dimension compared with the NEP’s focus on macro-economic stabilisation, infrastructure, social services and labour market conditions (Schätzl 1988: 46). During this period, rural poverty and unemployment rates both rose dramatically, due to drops in primary commodity prices in international markets (Ritchie 2004).
The ethnic dimension in rising economic inequality triggered political and social unrest in 1969 and induced the design and implementation of the NEP (see Hwok-Aun Lee, this volume). Towards meeting the NEP’s goals of restructuring the economy and reducing inequality between ethnic groups, fiscal policy helped inject tax and other sources of revenues to fuel policy thrusts, while creating incentives and disincentives that guided private investment and employment behaviour. Massive government expenditure and heavy government intervention in the economy were supported by newly discovered petroleum reserves, which prevented a dramatic increase in debt in the short term (Doraisami 2011: 9).

Introduced under the premiership of Tun Abdul Razak Hussein, these highly interventionist economic strategies flourished under Mahathir Mohammad, prime minister from 1982 to 2003, who adopted an extreme pro-Malay position and nationalist ‘Look East’ policy, marked by a combination of government subsidies and tariff protection (Ritchie 2004). As earlier, these fiscal incentives were supported by rising income from petroleum sales and expanding exports from foreign multinationals (Ritchie 2004). Nonetheless, with moderation of federal revenue growth over 1980–83 and a decline in internal sources of saving, this expansionary fiscal policy was no longer sustainable without over-relying on foreign borrowing (Narayanan 1996). Resulting twin deficits in fiscal position and balance of payments forced the Malaysian government to implement comprehensive structural reform programmes, with the aim of reducing spending and reordering national objectives to be more consistent with domestic resource availability (Vijayaledchumy 2003: 173).

Daim Zainuddin, finance minister in the mid-1980s, moved to cut development spending and curb current expenditures, while pushing for major privatisation initiatives in national industries such as airlines, telecommunications, shipping, electricity and heavy industry (Narayanan 1996). The remaining NFPEs also increasingly operated along commercial principles (IMF 1999). While these moves resulted in improvements in the federal budget and better external debt conditions, privatisation moves during this period were not only small and selective, but also arguably helped transfer state-controlled assets to private bumiputera entrepreneurs with close government ties (Adam and Cavendish 1995; Ritchie 2004).

Anwar Ibrahim, Daim’s successor as finance minister, continued Daim’s pro-private initiatives and maintained the fiscal line on curbing current expenditures, while introducing new measures to reduce income and corporate taxes. On the other hand, Anwar chose to shelve Daim’s proposal for a value-added tax (VAT) and did little to curb development spending, the majority of which went to infrastructure projects (Narayanan 1996). While some view Anwar as a rational politician who was unwilling to make a politically unpopular decision, others argue that he had little power to implement broader fiscal reform, as most oversight power resided with the EPU (Narayanan 1996; Ritchie 2004).

Although a fiscal surplus was achieved between 1993 and 1997 (see Figure 12.1), a deficit reappeared in 1998 and was maintained thereafter. Prolonged fiscal expansion after 1997 indicates that the crisis of that year might have served as a trigger and justification for increased spending. However, unsustainably high government expenditures, including massive infrastructural upgrading, counterbalanced by unstable petroleum levies, predated the crisis (Narayanan 1996).

**Fiscal deficit: economic and political perspectives**

Persistent fiscal deficits in Malaysia raise important theoretical and policy debates over both the nature and sources of those deficits, including issues of fiscal discretion, counter-cyclicality
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versus pro-cyclicality, reliance on petroleum-generated revenues, and the impact of political interests and institutions.

In analysing fiscal deficits in Malaysia, Narayanan (2007) finds these have been higher than in neighbouring countries as a result of lack of fiscal discipline. While Malaysia maintains an official commitment to counter-cyclical fiscal policies, that preference has not been borne out in reality. For example, Rafiq (2013) discovers that fiscal policy in Malaysia has been increasingly pro-cyclical over the last twenty-five years, as revealed by a strong positive correlation between changes in government spending and domestic economic conditions.

Other scholars have raised the issue of over-reliance on oil wealth or other natural resources as a major revenue source. Eifert et al.’s (2003) analysis of oil wealth and fiscal policy shows that the extent to which a country benefits from oil wealth is often unclear, limited or even negative. In Malaysia, reliance on natural resources as a revenue source has increased in recent decades, with the share of non-tax revenues from PETRONAS and petroleum and gas royalties exceeding 20 percent of non-tax revenue in 2007–10. As Narayanan (1996) points out, the future of fiscal management in Malaysia may depend on how well the country can reverse its current reliance on petroleum and tap into new and reliable sources of revenue.

Political interests and institutions may also serve as important factors in determining the direction of fiscal policy in Malaysia. Doraisami (2011) finds that Malaysia has the highest ratio of public servants to overall population among neighbouring countries, with wages and salaries of public servants as the largest line-item by function in annual budgets. Others suggest that coalition politics drive illiberal government intervention, noting a strong influence of political business cycles on the magnitude of expansionary fiscal policies (Ritchie 2004; Pepinsky 2007). Finally, there has been a lack of consistent commitment to liberalisation and privatisation, as fiscal and other economic policies have often been introduced to maximise coalition support for political and economic interests (Ritchie 2004; Narayanan 1996; Jomo and Hamilton-Hart 2001).

Monetary policy in Malaysia: institutions, history and central bank independence

Since its establishment, Bank Negara Malaysia (BNM) has served as the most important monetary policy-making body in Malaysia. Governed by a board of directors, BNM is tasked with multiple mandates, including maintaining price stability, sustainable economic growth and financial stability. In recent years, BNM has increasingly emphasised balancing risks to growth and inflation whenever a policy decision is made (Zeti 2009). BNM also oversees other financial authorities, such as Labuan Financial Services Authority, the Securities Commission of Malaysia, and the Malaysian Deposit Insurance Corporation (BNM 2013b).

BNM implements its commitment to price stability without an explicit inflation-targeting framework (McCauley 2006: 172). In reality, exchange rate stability represents another key monetary policy objective (McCauley 2006). In tackling competing imperatives, BNM claims that the key issue is the maintenance of a flexible exchange rate and monetary independence in the face of increasingly volatile capital flows (Ooi 2009).

Policy communication has been strengthened in recent years through regular release of policy announcements and frequent signalling through policy rates and monetary operations. Previously, monetary targets such as monetary aggregates were often kept as informal targets and not formally announced to the public (Cheong 2005: 209). Since 2004, a newly established monetary policy committee has met at least six times a year, issuing monetary policy statements on the same day (BNM 2013c). With the implementation of a new interest
framework, the overnight policy rate (OPR) has become the main indicator of monetary policy stance, with moderate adjustments usually between 25 and 50 base points to signal changes in monetary policy directions. Initially set at 2.70 in 2004, the policy rate was raised incrementally to 3.50 by 2008 to combat inflationary pressure, then gradually reduced to avoid curbing growth; it has remained at 3.00 since May 2011 (BNM 2013c).

The framework for monetary operations and liquidity management comprises instruments for both conventional and Islamic interbank money markets, as well as monetary operations on the foreign exchange market. BNM has taken efforts to widen the range of available monetary policy instruments on the domestic money market. Current monetary instruments on the conventional money market include uncollateralised money market borrowings, repo borrowings, BNM monetary notes and several others, whereas the introduction of Islamic monetary instruments based on shari’a concepts is intended to increase the effectiveness of monetary transmission mechanisms on the Islamic money market (BNM 2012, 2013a).

On the foreign exchange market, sterilised intervention is BNM’s major instrument, although it tends to work more effectively in combination with capital controls (McCauley 2006). While Malaysia abandoned its official commitment to bilateral exchange rate stability in 2005, sterilised intervention is still used to influence the level and volatility of exchange rates on a regular basis. On the other hand, the shutdown of the offshore market for ringgit in 1998 marked the beginning of de-internationalisation of the ringgit, which barred its international convertibility and forced foreign holders of ringgit assets to repatriate their assets (Pepinsky 2007: 149). Despite the development of a non-deliverable off-shore market in 2005, the re-internationalisation of the ringgit is still a topic under discussion, possibly to be pursued, cautiously and progressively, in the future (McCauley 2006; BNM 2013a).

Balancing growth and inflation: from monetary targeting to interest rate targeting

On 26 January 1959, BNM opened its doors as the central bank of Malaysia. In its early days, BNM focused on liquidity management in the financial system, primarily through prescriptions of interest rates and portfolio restrictions, which included ceilings on lending (BNM 2009). Similar to other central banks, BNM’s monetary policy often reflects its reaction to prevailing economic conditions, in particular when facing external shocks (Shaari 2008).

BNM’s commitment to price stability faced major challenges in the two global oil shocks in the early and late 1970s. Annual inflation in consumer prices reached a historical high of 17.3 percent in 1974, then spiked again to 9.7 percent in 1981 (World Bank 2013). Facing destabilising international monetary conditions, BNM focused during this period primarily on maintaining price stability and ensuring a stable currency (Shaari 2008: 12). By the mid-1980s, a sharp decline in global commodity prices brought the Malaysian economy and fiscal position again into trouble, and BNM stepped in to ease monetary policy, allowing the ringgit to depreciate. These steps worked in tandem with steps toward privatisation and liberalisation in fiscal and other macroeconomic policies to boost both domestic and export markets in a relatively short time.

The economy recovered with a growth rate of 5.4 percent in 1987, marking the beginning of a decade of economic expansion, with an average growth rate of 9.3 percent until the Asian financial crisis (World Bank 2013). Monetary management during this period focused on dealing with steadily growing inflationary pressures. The tight monetary policy stance signalled by the rise of domestic interest rates, however, juxtaposed against the general perception of an undervalued ringgit, attracted substantial inflows of short-term foreign
capital, which caused excess liquidity in the banking system and created a dilemma for monetary policy-making (Shaari 2008). Since sterilised intervention operations failed to constrain the infl ow of short-term capital, BNM was forced to implement several temporary exchange control measures in early 1994 (BNM 1999; Shaari 2008).

Prior to the mid-1990s, the major strategy for monetary policy was thus based on targeting monetary aggregates (Cheong 2005).^5^ The increasing volatility of capital infl ows in the early 1990s indicated that monetary aggregates were no longer stable targets, so a shift to interest-rate targeting was considered necessary to improve effective transmission of monetary policies (Cheong 2005). As Cheong (2005: 211) points out, the move was preconditioned by the liberalisation of interest rates since the 1970s, gradual financial deregulation, and a shift in financing patterns towards a more interest-sensitive market since the 1980s.

Central bank independence in Malaysia: a political economy perspective

An interesting comparison between fiscal and monetary policy in Malaysia is that monetary policy formulation and implementation have enjoyed higher levels of institutional and behavioural independence, coupled with an explicit mandate on major policy objectives (Byun 2006; Hamilton–Hart 2002; McCauley 2006). As Eijffinger and De Haan (1996) indicate, these provisions are important institutional devices for maintaining price stability, which provides a potential explanation for the relatively low inflation levels in Malaysian economic history. Furthermore, Malaysia has comparatively infrequent turnovers in the position of central bank governor; in Malaysia, terms average 6.6 years, compared with 3.2 years in neighbouring Thailand, for instance, which may indicate a higher level of behavioural autonomy (Cukierman and Webb 1995; McCauley 2006).^6^

In a comparison between Malaysia and South Korea, Byun (2006: 168) argues that BNM has seldom made use of interest rate controls or credit incentives to support industrial policy. Similarly, Hamilton–Hart (2002: 107) points out that the UMNO-led government’s most interventionist financial policies did not involve Malaysia’s central bankers, either. The behavioural independence BNM has enjoyed may have been usefully strengthened by significant legal guarantees (McCauley 2006). The original Central Bank Act 1958 (CBA 1958), revised in 1994, spelled out the major functions of BNM and provided the legal foundation for this behavioural independence; a new CBA in 2009 further strengthened BNM’s power through institutionalising everyday practices and expanding macro-prudential power (Zeti 2009).^7^

Nonetheless, some argue that this relative independence can be subject to informal political pressures and may be compromised at times. A review of central bank history in the 1980s by Byun (2006: 169) points out that the resignation of the third BNM governor may have had to do with a disagreement with then Finance Minister Daim Zainuddin, who removed the Capital Issues Committee from BNM control to push capital-intensive industrial deepening. In classifying central bank autonomy into political and economic dimensions, Arnone et al. (2008) find that BNM enjoyed a relatively lower level of political autonomy in comparison to economic autonomy in terms of daily operations on credit facilities and setting interest rates. ^8^ From this perspective, strengthened policy coordination between BNM and MOF during and after the recent global financial crisis may become a double-edged sword. A comparison between BNM annual reports in 2008 and 2009 indicates an implicit attitudinal change, from emphasising the limits of monetary policy as a demand management tool, towards stressing policy coordination between BNM and the rest of the government (BNM 2009,
2011a). On the one hand, there is a consensus among central bankers that strengthened coordination between fiscal and monetary policy can improve policy effectiveness on both sides and avoid conflicting goals. On the other hand, a joint report of the IMF and World Bank warned against potential intervention by MOF and advised BNM to stay independent and provide legal protection for its staff (IMF 2013).

Crisis, recovery and reform: the role of fiscal and monetary policy

Although economic crises always pose significant challenges, they sometimes create windows of opportunity for long-term macroeconomic policy and structural reform. Malaysia has implemented significant reform measures after both the Asian financial crisis (AFC) and the recent global financial crisis (GFC). Nonetheless, the pace and magnitude of reform in fiscal policy and monetary policy differ significantly.

After a decade of economic boom, the AFC’s strike to the Malaysian economy in 1998 was somewhat unexpected to international observers. Large capital inflows into the region before the crisis, mostly from offshore borrowing by banks and the private sector, created increasingly fragile economic and financial growth (Radelet and Sachs 2000: 117). The scenario was somewhat different in Malaysia, with net portfolio inflows often small or negative during the years before the crisis (Radelet and Sachs 2000: 117). Nonetheless, bank and corporate failures, juxtaposed with political uncertainties, in some countries in the region created contagion effects for countries with relatively sound economic fundamentals, such as Malaysia (Radelet and Sachs 2000: 136).

The withdrawal of foreign funds triggered a chain reaction both across countries and domestically, from one sector to another. In Malaysia, the evolution from currency crisis to fully-fledged financial economic crisis took place in a relatively short period: the ringgit depreciated by almost 40 percent at its nadir, the stock market collapsed, and the economy deteriorated from a 7.3 percent growth rate in 1997 to a 7.4 percent contraction in 1998 (BNM 1999; Zeti 2009; World Bank 2013). While BNM mentioned the IMF view that the AFC reflected domestic policy weaknesses in its 1998 annual report, it attributed the quick domestic contagion primarily to the rapid accumulation of short-term debt in the domestic private sector (BNM 1999).

Another surprise came when Mahathir and policy-makers in Malaysia chose to implement a distinct policy package that significantly differed from prescriptions offered by the IMF, with an expansionary fiscal and monetary stance in conjunction with the implementation of capital controls and a fixed exchange rate. The structural reforms conducted after the crisis primarily occurred in the financial sector, while an expansionary stance was maintained in fiscal policy. The IMF package implemented in other Asian countries, by contrast, provided rescue funds under strict conditions of fiscal contraction, immediate restructuring of the bank sector, tight domestic credit and immediate debt repayment (Radelet and Sachs 2000: 141). In criticising this approach, the Malaysian government argued that this prescription was based on a set of ideal assumptions of a perfect, self-equilibrating market system, which made it fundamentally flawed for facing volatile global markets and irrational collective sentiments (Mustapa 1999).

In comparison to the AFC, the impact of the recent GFC on the Malaysian economy has been more ephemeral and less significant in its magnitude. Table 12.1 provides a comparison of selected economic indicators in the two crises. As a small, export-oriented economy, Malaysia experienced its most significant economic downturn in early 2009, when the economy contracted by 6.2 percent amidst major declines in major exports and imports as
well as gross fixed investment (Doraisami 2011). However, the economy quickly rebounded in late 2009 and throughout 2010.

In a keynote address, BNM’s deputy governor attributed the quick recovery to sound counter-cyclical fiscal and monetary policy as well as previously successful financial restructuring and deepening (Ooi 2009). The fiscal packages came with a stronger emphasis on private sector recovery and development, in comparison to fiscal responses during and after the AFC, which focused on boosting public sector investment. On the other hand, unlike earlier unconventional measures on the foreign exchange market, Malaysia’s monetary policy responses to the GFC primarily focused on conventional measures such as adjustments to policy rates and statutory reserve requirements, and targeting monetary operations.

### Fiscal policy: responses to crises and proposals for reform

Fiscal reform in Malaysia has moved at a much slower pace than have monetary policy reform and financial restructuring. Malaysia’s initial fiscal policy stance during the AFC was in fact similar to IMF recommendations, with a tightened operational budget aimed at reducing the current account deficit and countering inflationary pressures arising from the ringgit’s depreciation (Vijayaledchumy 2003). However, as the situation continued to deteriorate, the administration’s fiscal policy stance shifted quickly from contractionary to expansionary. A stimulus package of RM7 billion was issued in 1998 along with an announcement of a target federal deficit of 25 percent of GDP (Vijayaledchumy 2003). As a result of these fiscal moves, fiscal deficit re-emerged after five consecutive years of surpluses.

### Table 12.1 Selected economic indicators, 1997–2000 and 2007–10

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP growth (annual %)</th>
<th>Inflation(^a) (annual %)</th>
<th>External balance(^a) (US$ million)</th>
<th>Official exchange rate(^c) (per US$)</th>
<th>Central government debt (% of GDP)</th>
<th>Total reserves (% of external debt)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Before and after Asian financial crisis</strong></td>
<td></td>
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</tr>
<tr>
<td>1997</td>
<td>7.3</td>
<td>2.7</td>
<td>0.9</td>
<td>2.8</td>
<td>NA</td>
<td>45.5</td>
</tr>
<tr>
<td>1998</td>
<td>−7.4</td>
<td>5.3</td>
<td>22.0</td>
<td>3.9</td>
<td>NA</td>
<td>61.9</td>
</tr>
<tr>
<td>1999</td>
<td>6.1</td>
<td>2.7</td>
<td>25.1</td>
<td>3.8</td>
<td>NA</td>
<td>73.7</td>
</tr>
<tr>
<td>2000</td>
<td>8.9</td>
<td>1.5</td>
<td>19.2</td>
<td>3.8</td>
<td>NA</td>
<td>68.3</td>
</tr>
<tr>
<td><strong>Before and after global financial crisis</strong></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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</tr>
<tr>
<td>2007</td>
<td>6.3</td>
<td>2.0</td>
<td>19.9</td>
<td>3.4</td>
<td>40.1</td>
<td>161.7</td>
</tr>
<tr>
<td>2008</td>
<td>4.8</td>
<td>5.4</td>
<td>22.3</td>
<td>3.3</td>
<td>39.8</td>
<td>136.2</td>
</tr>
<tr>
<td>2009</td>
<td>−1.5</td>
<td>0.6</td>
<td>20.3</td>
<td>3.5</td>
<td>50.8</td>
<td>138.6</td>
</tr>
<tr>
<td>2010</td>
<td>7.2</td>
<td>1.7</td>
<td>17.2</td>
<td>3.2</td>
<td>51.2</td>
<td>125.1</td>
</tr>
</tbody>
</table>

*Source: World Bank, *World Development Indicators* (various years).*

**Notes:**

\(^a\) Consumer prices.

\(^b\) Goods and services.

\(^c\) Period average.

NA = Not available.
In claiming that the economy has fallen into a vicious cycle, the Malaysian government asserted that a tight fiscal stance would intensify rather than alleviate the crisis. In addition, an expansionary fiscal policy with a focus on public sector investment was viewed as necessary given that the private sector was considered more a problem rather than the solution (BNM 1999; Mustapa 1999). Interestingly, actual fiscal contributions failed to meet planned targets and accounted for only 1.5 percent of GDP in 1998, which in the IMF’s view, was the result of a relative lack of automatic stabilisers in both tax and expenditure systems (IMF 1999).

Rather than showing concern for re-emerging fiscal deficits and implementation issues in its fiscal stimulus package, however, the Malaysian government maintained an expansionary fiscal stance between 1999 and 2003, which continued to be justified in terms of the lacklustre performance of the private sector and as counter-cyclical and pre-emptive responses to a global economic slowdown (EPU 2013a). At the same time, the government took few measures in the post-AFC period to correct over-reliance on petroleum-related revenues, which continued to expand in the 2000s.

In this regard, the GFC provoked a fiscal policy response that differed in both magnitude and effectiveness, with an explicit concern over fiscal sustainability. In the early stages of the external shock, the finance minister introduced an initial stimulus package of RM7 million, financed from savings accumulated from a reduction in fuel subsidies earlier in the year (BNM 2009). A second stimulus package was introduced in 2009, with expansionary measures emphasising strong resumption of private consumption and investment, as well as enhancing the role of the private sector as the engine of economic growth (BNM 2011a). While there were still many components in the stimulus package that were for the benefit of the public sector and civil servants, the expansionary fiscal stance was altered in 2010, in contrast to the continued growth of deficits following the AFC.

The introduction of the New Economic Model (NEM) in 2010 aimed to transform Malaysia into a high-income economy without falling into the middle-income trap, and put the private sector at centre-stage for economic upgrading (Ahmad 2009; EPU 2013b). While political stability was considered as a necessary component, the model also emphasised restoration of Malaysia’s fiscal position to a more sustainable level, as well as recalibration of subsidy distributions and the gradual dismantling of the open-ended protection of certain industries (Ahmad 2009; EPU 2013b). Fiscal consolidation was thus considered imperative, as the EPU expressed concern over investor attitudes towards unsustainable sovereign debt levels as well as a projected decline in domestic petroleum production (EPU 2013b).

Proposals for a VAT also re-emerged as MOF announced its plan to introduce a new goods and service tax (GST) in the coming years, which would serve to streamline the current tax structure and improve its transparency, while broadening the tax base (MOF 2013a). As mentioned before, Daim Zainuddin’s VAT proposal was shelved due to political unpopularity in the 1980s. While the new tax system may provide a more neutral structure across certain industries, supplies for agriculture, exports and public sector products are considered as either zero-rated or exempt categories (MOF 2013a). The effectiveness of the new tax system in improving transparency and neutrality, as well as providing a stable source of revenue, is thus yet to be tested. On the other hand, the establishment of a Fiscal Policy Committee chaired by the prime minister and a Fiscal Policy Office within the MOF signalled further centralisation and coordination of policy-making (MOF 2013a). Nonetheless, the political implications of these institutional reforms are unclear, as they may well provide new venues for political intervention in fiscal policy formulation and implementation.
Monetary policy: responses to crises and continued modernisation

Compared with fiscal reform, which began to take shape only in recent years, monetary policy modernisation proceeded relatively smoothly after the AFC, although a selective and progressive approach was emphasised for certain liberalisation and reform measures, such as on the foreign exchange market. While policy coordination and stronger intervention by the Prime Minister’s Office and MOF are often seen in crisis periods, the overall balanced-risk approach between growth and inflation has not been compromised and monetary policy has quickly normalised after the crises.

During the AFC, volatile short-term capital flows and exchange rate volatility undermined the ability of BNM to influence domestic interest rates through regular monetary transmission mechanisms. With the implementation of selective exchange rate controls and a fixed exchange rate, BNM claimed that a greater degree of monetary autonomy was temporarily achieved to avoid the impossible trinity of flexible exchange rates, free capital flows and independent monetary policy (Cheong 2005). In its annual report for 1998, BNM indicated that monetary operations in dealing with the crisis were targeted at managing liquidity to maintain interest rates at levels that were sufficient to promote economic activity, while ensuring a positive return to depositors (BNM 1999).

As the economy started to recover, the Malaysian government and BNM took measures to restructure the financial sector, with plans to consolidate domestic financial institutions and improve balance sheets and corporate governance, as well as to liberalise price determination in the service sector (Cheong 2005; Zeti 2009). A new monetary policy framework was a natural step following strengthened financial risk management and a more market-based price determination framework (Cheong 2005). The introduction of the OPR as the new interest rate target for monetary policy, as well as regular announcements of target rates, allowed for greater clarity in policy communication, and thus increased the role of expectations in monetary policy-making (BNM 2009).

Since effective transmission of policy signals such as changes in policy rates depends on the effectiveness of relevant mechanisms, BNM also took further measures to adapt its monetary instruments to correspond to the changing domestic and external financial environment (Ooi 2008). While the conventional banking system remains the major source of financing for the private sector, BNM has expanded its monetary instruments to incorporate capital-based and Islamic monetary instruments (Ooi 2008).

When the GFC hit the Malaysian economy in 2009, the financial system was relatively sound, with improved balance sheets, while BNM had matured its practice using OPRs in both conventional and Islamic financial markets. Instead of resorting to AFC measures such as capital controls and fixed exchange rates, BNM chose to rely on a more conventional approach, using interest rate and monetary operations, while preserving previous liberalisation measures on foreign exchange administration (BNM 2009, 2011a, 2011b).

At the beginning of the crisis, BNM adopted a balanced-risk approach for growth and inflation, as usual. The OPR remained unchanged until November 2008, when it was clear that the downturn in the economy greatly outweighed inflationary pressures (BNM 2009, 2011a). Even so, BNM emphasised in its 2008 annual report that monetary policy has its limits when it comes to demand management (BNM 2009). That tone changed in the 2009 report, in which BNM explained its more comprehensive measures to reduce policy rates and statutory reserve requirements much further, as well as to increase coordination between BNM and other government machinery (BNM 2011a, 2011b). In some way, this change of
tone signalled that the relatively autonomous decision-making by BNM in the earlier crisis period would be less the case as this crisis deepened.

Despite the softening of BNM positions during the crisis, normalisation of monetary policy practices also began quickly once the growth–inflation balance changed. By early 2010, BNM had raised the policy rate repeatedly, given concerns that a low rate over an extended period could encourage risk-taking behaviour and excessive credit growth (BNM 2011a, 2011b). Liberalisation of foreign exchange administration rules continued after the crisis, with increasingly relaxed conditions for domestic corporations, Islamic banks and residents (BNM 2014). Finally, the integration of major financial service laws into the Financial Services Act 2013 and the Islamic Financial Services Act 2013 empowered BNM to further specify standards and issue directions to operators on both the conventional and Islamic financial markets (BNM 2013b).

Conclusion

Macroeconomic policy in Malaysia is designed to balance among key objectives such as growth, stability and equity. While both fiscal and monetary policy serve development and stabilisation goals, fiscal policy-making in Malaysia involves a more significant ethnic and political dimension, while monetary policy has been largely focused on ensuring price and financial stability. Although MOF often serves as the main physical centre for fiscal policy formulation and implementation, actual decision-making power resides more with the Prime Minister’s Office. The NEP and the ‘Look East’ policy created opportunities for the government to adopt a highly interventionist approach favouring bumiputera entrepreneurs with strong government ties and establishing an alliance with foreign capital (Narayanan 1996). Fiscal deficits have been the norm except in the early 1990s and continued to expand until 2009.

The unsustainability of this trend forced the Malaysian government eventually to begin to adjust its fiscal policy orientation and to call for reducing the ‘dependency syndrome’ of bumiputera entrepreneurs (Ahmad 2009). Proposals on reforming the tax structure as well as for fiscal consolidation may help alleviate the current fiscal imbalance, although the directions and effectiveness of these proposals are not yet clear, given potential political influence and room for policy discretion.

While fiscal reform is yet to take shape, BNM has used its relative behavioural independence to institutionalise its practices and to modernise Malaysia’s monetary policy framework. It has seldom abandoned a balanced-risk approach, weighing growth and inflation, even when facing external shocks and economic downturns. Efforts to implement a new interest rate framework and to improve monetary transmission mechanisms may complement moves for further financial deepening in conventional and Islamic financial markets, as well as the gradual liberalisation of the foreign exchange market, with the ultimate goal of reinternationalising the ringgit. Nevertheless, the influence of political factors has not completely faded, especially during crisis periods, while an informal commitment to exchange rate stability may create policy dilemmas when facing future external shocks.

Notes

1 NFPEs are public enterprises in which 50 percent or more of equity is held either directly by the government or indirectly through other public enterprises. Reforms in recent decades allow NFPEs to operate on an increasingly commercial basis (IMF 1999).
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2 From 1980 to 1983, net foreign borrowing as a source of government finance increased dramatically, from RM310 million to RM4,569 million.
3 Yet cognate issues arise, too, in other developing countries; see Fatás and Mihov 2003; Manasse 2006.
4 An IMF estimate shows that the ringgit faced sustained upward pressure, and gradually strengthened by about 15 percent in real effective terms, between 1990 and 1997 (IMF 1999: 28).
5 Monetary aggregates are classified into M1 (currency in circulation and demand deposits), M2 (M1 plus narrow quasi-money, defined as the sum of deposits or interest-bearing instruments) and M3 (M2 plus deposits placed with other banking institutions) (BNM 2013d).
6 According to Cukierman and Webb (1995), political influence on the central bank can be measured by the probability of a central bank governor’s being replaced shortly after a political change of government.
7 For example, the 2009 CBA charged BNM with the tasks of obtaining information for risk management purposes and taking early actions to avert and manage crises (BNM 2009).
8 Following Grilli et al. (1991), Arnone et al. (2008: 7) define political autonomy in terms of the ability of central banks to select the final objectives of monetary policy, including considerations of appointments of key personnel, as well as legal obligations and provisions. Economic autonomy is defined in terms of operational autonomy, such as constraints on government access to credit facilities at the central bank and the central bank’s ability to set the policy rate.
9 See, for example, a discussion by Nordhaus et al. (1994), which indicates that separation of powers in monetary and fiscal policy-making, as occurs in many large countries, often results in conflicting policy objectives, as indicated by high fiscal deficits and tight monetary policy with overly high interest rates.
10 The new GST is a broad-based consumption tax and will replace the current sales and service tax introduced in the 1970s, with distinctions among zero-rated, exempt and standard-rated supplies (MOF 2013).

Bibliography


