



Faculty of Economics and Business

Impact of Debts on Economic Growth in Malaysia

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Impact of Debts on Economic Growth in Malaysia

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DECLARATION

I hereby declare that this research titled “Impact of Debts on Economic Growth in Malaysia” is the result of my investigation, except where otherwise stated. All sources of data or information utilised in this research are acknowledge and a list of references is appended. The thesis has not been accepted for any degree and is not concurrently submitted in candidature of any other degree.

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ABSTRACT

Malaysian economy has experienced several financial crises. In addition, the policies implemented by the government to sustain economic growth have led to a budget deficit and a high level of debt. The ballooning effect of debts has raised concern on whether current debt levels could still be sustainable in the future to stimulate economic growth or will instead become a burden on the future generation. Hence, this study examines the impact of total debts at aggregate level, the national debt, and the external debt on Malaysia's economic growth, respectively. This study adopted an Autoregressive-Distributed Lag (ARDL) model to estimate the impact of different types of debt on Malaysia's GDP growth. The Threshold Autoregression (TAR) model was also used to determine the threshold value of national and external debts. The empirical findings indicate that total debts and national debt have a negative and significant impact on Malaysia's GDP growth in the long run while the impact of external debt was found to be positive but insignificant in the long run. Meanwhile, the TAR model showed that the estimated threshold level for national debt and external debt was 68% of GDP and 38% of GDP, respectively. The empirical findings indicate that the impact of both national and external debts turned positive when the debt level was exceeded the estimated threshold level.

Keywords: National debt, external debt, threshold, ARDL, TAR

Impak Hutang Terhadap Pertumbuhan Ekonomi Malaysia

ABSTRAK

Ekonomi Malaysia telah mengalami beberapa krisis kewangan. Selain itu, dasar yang dilaksanakan oleh kerajaan untuk mengekalkan pertumbuhan ekonomi telah menyebabkan defisit belanjawan dan kadar hutang yang tinggi. Kesan hutang yang semakin tinggi telah menimbulkan kebimbangan antara faktor tahap hutang semasa untuk bertahan pada masa depan bagi merangsang pertumbuhan ekonomi atau menjadi beban pada masa depan. Oleh itu, kajian ini meneliti kesan keseluruhan hutang pada peringkat agregat, hutang negara, dan hutang luar negara terhadap pertumbuhan ekonomi Malaysia. Kajian ini menggunakan model 'Autoregressive-Distributed Lag' (ARDL) untuk menganggar kesan pelbagai jenis hutang terhadap pertumbuhan KDNK Malaysia. Model 'Threshold Autoregression' (TAR) juga digunakan untuk menentukan nilai ambang hutang negara dan luaran. Penemuan empirikal menunjukkan bahawa jumlah hutang dan hutang negara mempunyai kesan negatif dan signifikan terhadap pertumbuhan KDNK Malaysia dalam jangka masa panjang sementara kesan hutang luar negara didapati positif tetapi tidak signifikan dalam jangka masa panjang. Sementara itu, model TAR menunjukkan bahawa tahap ambang untuk hutang negara dan hutang luar negara dianggarkan adalah 68% dan 38% daripada KDNK. Penemuan empirikal menunjukkan bahawa kesan kedua-dua hutang negara dan luaran menjadi positif apabila tahap hutang berada di atas paras ambang yang dianggarkan.

Kata kunci: *Hutang negara, hutang luar negara, nilai ambang, ARDL, TAR*

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CHAPTER 1

INTRODUCTION

1.1 Introduction

Sustainable economic growth has become an important issue in all countries. It is particularly important for a developing country like Malaysia, which is currently facing various challenges in improving its economic growth to reduce its burden of debt. The term ‘economic growth’ is related to economic progress and development; in general, it refers to an increase in aggregate productivity level over a certain time period. A country increases its debt when it experiences slow economic growth. Debt can be categorised into public and private sectors debt. Public sector debt can be defined as any borrowing by the government and Non-Financial Public Enterprises (NFPEs), while private sector debt is the borrowing by individuals and businesses. Money borrowed and owed by the government is referred to as national debt, which can be further categorised into domestic debt and offshore borrowing. Domestic debt refers to the accumulated level of debt owed by the government to lenders within the country whereas offshore borrowing is the outstanding money owed by the government to external lenders. Thus, national debt includes debt denominated in ringgit and foreign currency. Meanwhile, external debt is the outstanding money owed by public and private sectors to a foreign country, including foreign governments, banks, or international financial institutions. External debt comprises short-term debt, generally with an original maturity of less than one year; and long-term debt, with an original maturity of more than one year.

Debt is an important instrument that a country can use to generate production and enhance economic development. The Malaysian government usually raises funds from the domestic market to support the principal repayment of domestic debt, to finance budget deficit, and to accommodate development expenditures through the issuance of debt securities. Funds raised through domestic sources stimulate private savings and investment, while strengthening the domestic financial market, as they provide depth and liquidity to the market. The economic theory suggests that prudent utilisation of debt is likely to promote growth, as it achieves social goals and accelerates the pace of infrastructure development (Lee & Ng, 2015). At low levels of debt, new borrowings could be used to finance capital to improve the country's productive capacity, thus stimulating economic growth. As stated by Burhanudin et al. (2017), the allocation of debt for productive expenditure will eventually help sustain long-term economic growth for the country. A high degree of productive capacity is conducive to high output, in turn, making it easier for a country to service its debt. Besides that, the government also borrows to finance economic and education expenditures. Economists view that the debt incurred in education and economic expenditures respectively escalate physical and human capital, therefore, making it a source of economic growth (Bakar & Hassan, 2008).

However, the issue of debt arises when debt servicing capacity does not keep pace with the high growth of debt. When a country's debt becomes excessively large compared to its export earnings and gross national product (GNP), the country will face difficulties in achieving economic growth and human development, as excessive debt will eventually drain the social sector's resources and weaken the vitality of the economy. Hence, to prevent a

country from adding arrears or to default on debt, the government has to divert resources in order to repay the accumulated debts.

On the contrary, when debt accumulation goes above a certain limit, it will distort investment and slow down economic growth (Akram, 2011; Anifowose, 2016; Frimpong & Oteng-Abaye, 2006; Were, 2001). Besides, Kharusi and Ada (2018) and Maane et al. (2008) also pointed out that an excessive level of debt crowds out private investment due to the competition between the government and the private sector for private savings. Furthermore, critical level debt accumulation may scare away investors, who will question the country's abilities to repay its debt to creditors. The creditors will be demanding a higher interest rate in return for a greater risk of default, thus making it more costly for a country to service its outstanding debt. Therefore, reasonable borrowing promotes economic growth, but if it goes above a certain threshold level, additional debt will negatively impact growth, rendering the country worse off.

Although numerous research has been proposed to assess the influence of debt on the economy, the findings on this subject are rather mixed across countries (Akram, 2011, 2017; Babu et al., 2015; Egbetunde, 2012; El-Mahdy and Torayeng, 2009; Kharusi and Ada, 2018; Mohanty and Mishra, 2016; Safdari and Meihrizi, 2011; Udeh et al., 2016; Were, 2011; Zaman and Arsla, 2014). In the context of Malaysia, Burhanudin et al. (2017), Haris and Mohammad (2015), and Lim et al. (2017) found supporting evidence of national debt stimulating growth. However, Lee and Ng (2015), Rahman (2012), and Mok and Ismail (2015) reached a different conclusion, finding that national debt actually hampered growth. Meanwhile, from the external debt perspective, Loganathan et al. (2010) revealed that debt

positively impacted growth. Bakar and Hassan (2008) also reached a similar conclusion—that the external debt increased growth. In contrast, Choong et al. (2010) reached a different conclusion—external debt hampered the country's growth.

Moreover, some studies found different conclusions on the influence of debt non-linearity on the economy (Cecchetti et al., 2011; Kueh et al. 2007; Mohd Daud et al. 2013; Padoan et al., 2012; Presbitero, 2010; Reinhart and Rogoff, 2009). In the context of Malaysia, Kueh et al. (2017) found that national debt positively impacted growth when it was below a certain threshold level while external debt positively impacted growth when it surpassed the threshold level. However, Mohd Daud et al. (2013) reached a different conclusion and found that external debt negatively impacted the country's economy when it surpassed the threshold level.

There are few empirical studies that support and disprove the effect of debt in stimulating the country's economy. The effects of debt on the country's growth remain questionable for both policymakers and economists. As far as the study is concerned, only a limited number of studies have examined the impact of the national debt, the external debt, and the total impact of both debts on the growth of Malaysia's economy.

Hence, the uncertainty of debt on economic growth motivated this study to examine the impact of national and external debts on the growth in the context of Malaysian economy. Furthermore, not many empirical studies have investigated the threshold level of both national and external debts on the Malaysian economy. In addition, this study attempts to identify the threshold level of both Malaysia's national and external debts. An

Autoregressive-Distributed Lag (ARDL) model was utilised to analyse the impact of different types of debts on the economy. Additionally, this study also employed a Threshold Autoregression (TAR) model to determine the threshold level for debts for Malaysia, the results of which will provide valuable information to policymakers in monitoring the country's debt level. Such an understanding will also provide policymakers with a better guideline for formulating policies.

1.2 Background of the Study

Malaysia's national debt comprises domestic debt and the government's offshore borrowing, which is also known as the government's external debt. The government raises funds from the domestic market through the issuance of debt securities, which include Malaysian Government Securities (MGS), Malaysian Treasury Bills (TBs), and Government Investment Issues (GIIs). MGS, otherwise known as government bonds, are fixed income government securities that are traded on the bond market. The Malaysian government issues MGS to finance long-term development projects with an original maturity of more than one year. Apart from that, TBs are short-term securities issued by the Malaysian government to finance working capital. TBs are sold through competitive auctions facilitated by Bank Negara Malaysia. Meanwhile, GIIs are long-term non-interest bearing securities issued by Malaysia's government based on Islamic principles. The funds are used to finance development expenditures with a maturity of more than one year. Meanwhile, Malaysia's external debt comprises public and private sector debt, which includes offshore borrowings, non-resident (NR) holdings of ringgit-denominated debt securities, NR deposits, trade credits, and other liabilities.

In the early 1980s, the United States (US) introduced a high interest rate policy, which triggered an economic downturn in developed countries, resulting in the massive collapse of world commodity trade. Malaysia's economy experienced a sharp contraction in 1982 and thus, to sustain growth, the government adopted an expansionary fiscal policy by increasing the development expenditure, which eventually led to higher deficit of 16.2 per cent of GDP. Hence, the gross domestic borrowing was recorded at MYR 7,071 million of which 86 per cent was used to finance the budget deficit. Figure 1.1 shows a graph of Malaysia's domestic borrowings from 1980 to 2018.

In 1985, Malaysia's economy fell into recession. The counter-cyclical policies implemented by the government further led to a twin deficit. Thus, the government increased domestic borrowing to finance the budget deficit, which resulted in a higher level of national debt in the following years. Figure 1.2 shows a graph of Malaysia's national debt level from 1980 to 2018. The national debt level increased by a total MYR 26 million, from MYR 63 million in 1985 to MYR 89 million in 1988. Meanwhile, the level of domestic debt in terms of GDP also arose from 52 per cent in 1985 to 68 per cent in 1988 (Figure 1.1).

Over the period of 1993 to 1997, Malaysia had a budget surplus and hence the Federal Government did not raise any loans from the international capital market. Malaysia's external debt level grew steadily from MYR 69 billion in 1993 to MYR 97 billion in 1996 (Figure 1.3). When the Asian Financial Crisis erupted in 1997, Malaysia faced a sharp Ringgit depreciation. With the weakening of the Ringgit, Malaysia's total outstanding external debt increased to MYR 170.7 billion in 1997, a total increase of MYR 72 million in one year period. Figure 1.3 shows a graph of Malaysia's external debt level from 1980 to

2018. The graph clearly shows a sudden increase in external debt level in the year 1997. Meanwhile, the Federal Government's offshore borrowing rose to MYR 12.9 billion at the end of 1997 from MYR 10.7 million mainly due to an exchange revaluation loss of MYR 4.2 billion. External borrowings by the NFPES rose to MYR 52 million compared to MYR 29 million in 1996 due to the financing of domestic capital expenditure, overseas investment, and a large repayment of expensive loans. Therefore, the Federal Government adopted an expansionary fiscal policy to prevent further economic contraction, which eventually led to a budget surplus that turned into a deficit in 1998. The Federal Government increased domestic borrowings from MYR 3,000 million in 1997 to MYR 17,990 million in 1998 to tackle the budget deficit. The national debt continued to rise until it reached MYR 103 billion in 1998 from MYR 89 billion in 1997.

In 2003, the counter-cyclical expenditure was implemented, causing in a higher deficit of 5.3 per cent of GDP. Thus, the gross domestic borrowings increased from MYR 18,000 million in 2002 to MYR 41,850 million in 2003. A total of 44 per cent of the domestic borrowing was used to finance the budget deficit while the remaining balance was used for principal repayment. On the other hand, Figure 1.3 shows a downward movement in external debt level from 2005 to 2006 mainly due to the appreciation of the ringgit, which contributed positively to Malaysia's external debt position as well as in reducing its debt servicing payment in 2006.

Apart from that, the government introduced a MYR 60 million economic stimulus plan to sustain the country's growth from the global recession in 2008. However, an overall deficit of 7 per cent of GDP was registered in 2009. Figure 1.1 clearly shows a dramatic

upward movement in domestic borrowing from 2008 to 2009 due to a total of MYR 33 million being raised by the government to finance the budget deficit. In the meantime, the Malaysian government imposed a debt ceiling of 55 per cent of GDP in July 2009. External debt increased steadily to MYR 232 billion in 2009, a total increase of MYR 48 billion in 6 years. During this time, private sector debt represented the largest component of total external debt while government offshore borrowings remained the smallest component of total external debt.

During the period 2010 to 2014, Malaysia's strong financial position—supported by ample liquidity in the financial system and high domestic savings—enabled the government to continue to finance its fiscal deficit from the domestic market. Therefore, national debt continued to rise from MYR 407 billion in 2010 to MYR 582 billion in 2014. Malaysia redefined its external debt in the first quarter of 2014. According to the new definition, trade credits, NR deposits, NR holdings of ringgit-denominated government bonds, and other liabilities will be included in the external debt. Hence, Figure 1.3 shows a dramatic increase in external debt, causing the outstanding debt to stand at MYR 747 billion or 69.6 per cent of GDP in 2014.

In 2018, Malaysia's national debt reached MYR 741 billion, equivalent to 51.8 per cent of GDP, primarily due to a higher domestic debt issuance to finance the deficit in the budget balance. Figure 1.4 shows the graph of Malaysia's national debt by instruments as at end 2018. Domestic debt level was recorded at MYR 719 billion where MGS remained the largest component of domestic debt followed by GIIs and TBs. Meanwhile, offshore borrowings stood at MYR 21 billion with market loans still having the largest contribution

followed by project loans. Malaysia's external debt was recorded at MYR 924 billion, equivalent to 64.7 per cent of GDP, where the private sector was the main contribution to the debt level, followed by the NR holdings of ringgit-denominated government bonds, public enterprises, NR deposits, and lastly the Federal Government's offshore borrowing.

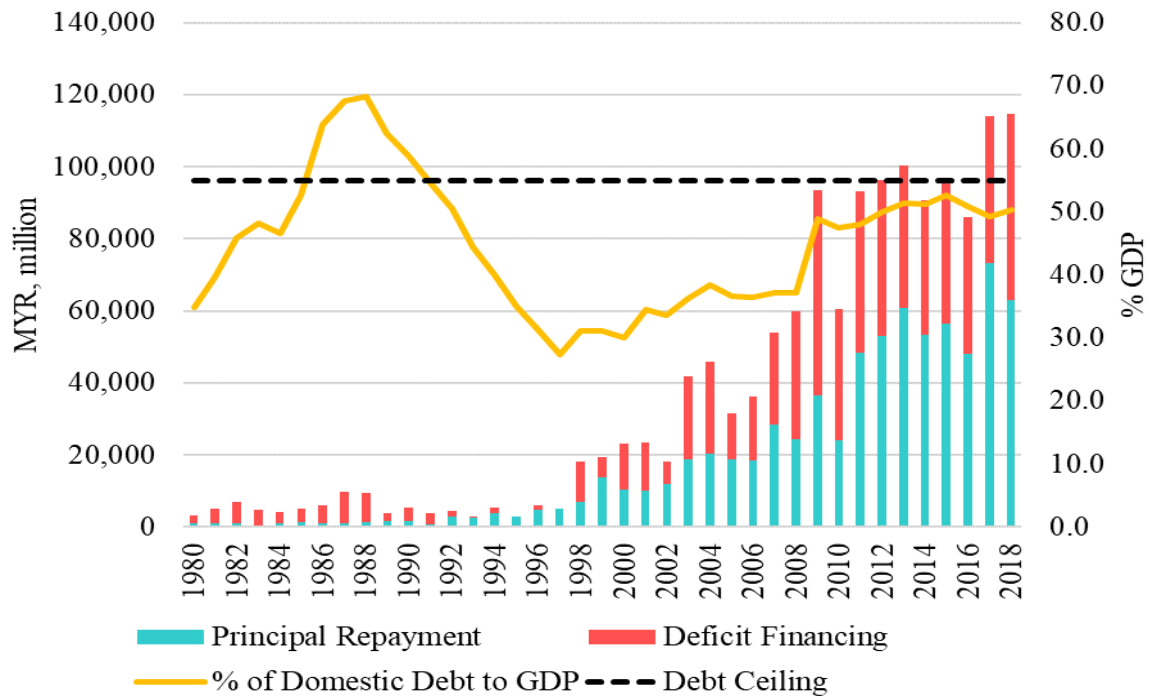


Figure 1.1: Malaysia's Domestic Borrowings (1980-2018) (Source: Bank Negara Malaysia, 2018)

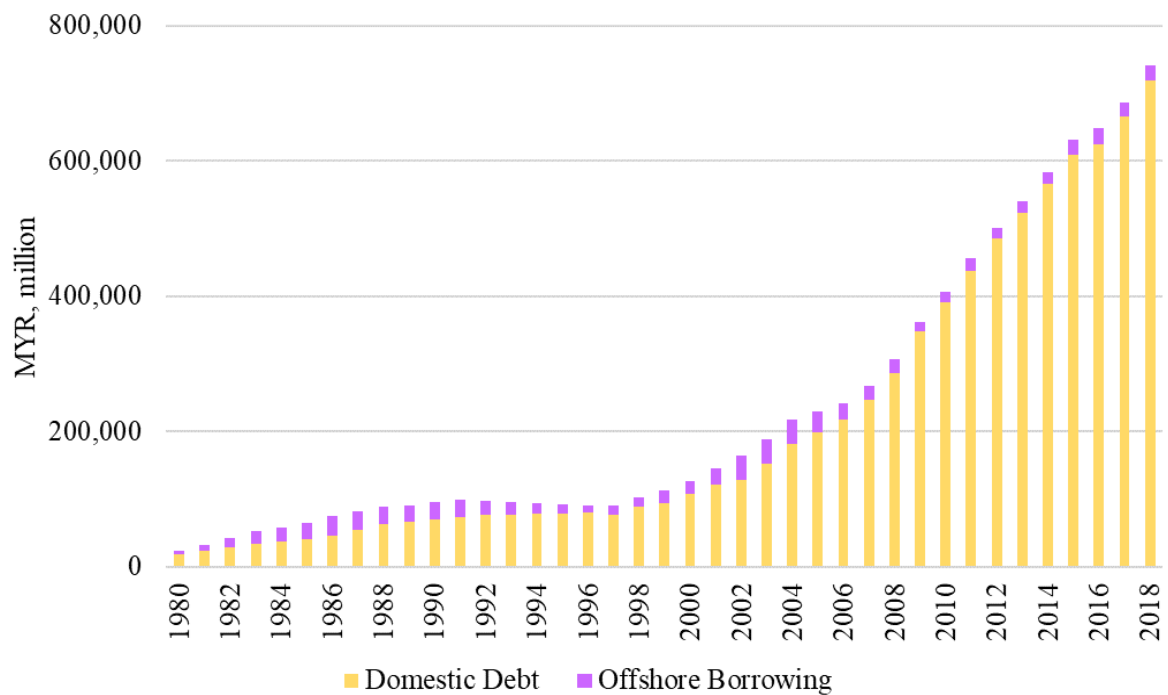


Figure 1.2: Malaysia's National Debt (1980 - 2018) (Source: Bank Negara Malaysia, 2018)

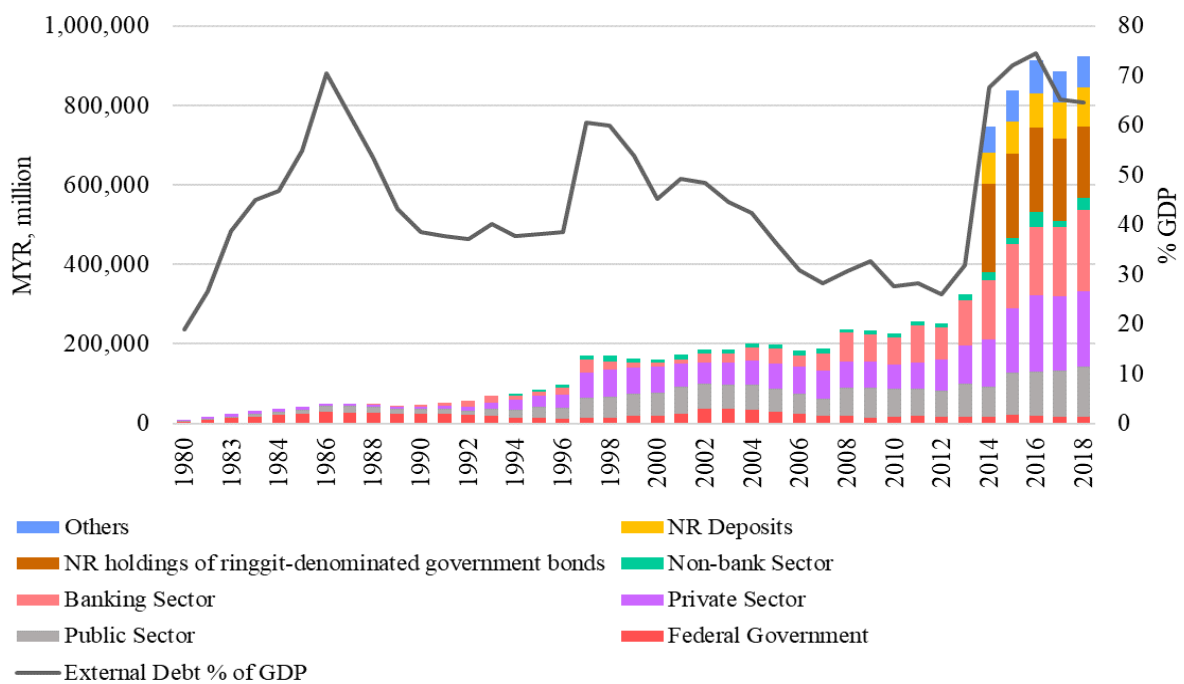


Figure 1.3: Malaysia's External Debt (1980 - 2018) (Source: Bank Negara Malaysia, 2018)

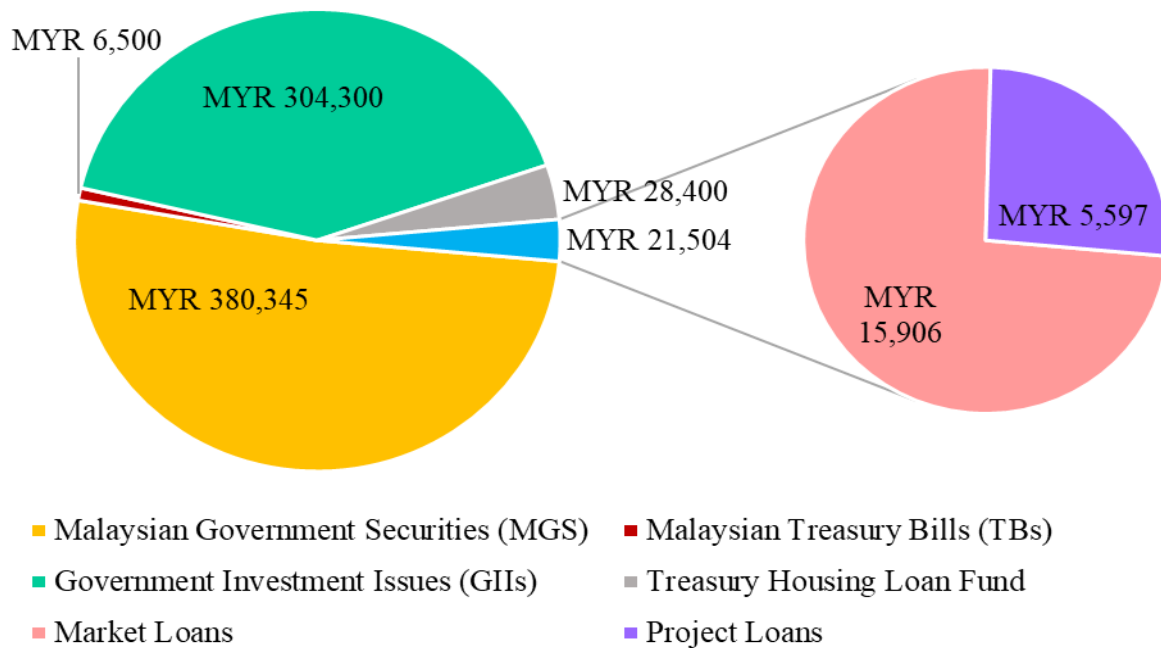


Figure 1.4: Malaysia's National Debt by Instruments (2018) (Source: Bank Negara Malaysia, 2018)

1.3 Problem Statement

Before the crisis erupted, Malaysia's economic performance had been tagged as one of the best among the Asian countries, as it had maintained a high growth rate and a low inflation rate. However, Malaysia's golden age did not last the decade. The US adopted a high interest rate policy, which caused a massive collapse in the world commodity trade, which eventually triggered Commodity Shock in Malaysia. The Heavy Industries Corporation of Malaysia (HICOM) drained the national treasury, significantly increasing Malaysia's external debt in the mid-1980s (Jomo, 2006). The counter-cyclical policies implemented by the Malaysian government to sustain economic growth have led to a twin deficit and an increase in the external debt position.

When Malaysia was still in the recovery stage from the massive impact of the commodity shock, the sudden collapse of the Thai baht immediately sparked another crisis in Asia, known as the Asian Financial Crisis (AFC), in July 1997. Sadly, Malaysia was not spared from this tragedy. In 1997, the country's total external debt reached MYR 170 billion from MYR 45 billion in 1990. The total external debt in terms of GDP in Malaysia fluctuated from 38 per cent in 1990 to 40 per cent in 1993, subsequently falling to 38 per cent in 1996, and then further increasing to 60 per cent in 1997. The Global Financial Crisis erupted in 2008, again hitting Malaysia's economy hard. After having gone through a bumpy road to recover from the AFC, the country enhanced the foundation of its financial and banking sectors to prevent any financial meltdowns in the future. Hence, the attacks from the global financial crisis were confined to the Malaysian trade and gross domestic product (GDP) only. Malaysia also redefined its external debt in the first quarter of 2014. In line with the revision, Malaysia's external debt tripled to MYR 747 billion in 2014 and further expanded to MYR 924 billion or 64.7 per cent of GDP in 2018. When a country's debt becomes excessively large compared to its export earnings and gross national product (GNP), the country will face difficulties in achieving economic growth and human development, as excessive debt will eventually drain the social sector's resources and weaken the vitality of the economy. Thus, Bakar and Hassan (2008), Loganathan et al. (2010) and Choong et al. (2010) found that external debt has impact on economic growth of Malaysia. Therefore, it is important to determine whether Malaysia's external debt will be able to stimulate the economy in the future or instead become a substantial burden for future generations.

The high level of debt has had a significant influence on Malaysian economy up to an optimal level where debt servicing sets in and affects the country's economy as the focus