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The Impact of Government Debt on Malaysia's Economic Growth

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ABSTRACT

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The Malaysian economic situation has not been improving since the 2010 world economic crisis. The vulnerability of Malaysia government to accumulating high debt is rather worrisome. This study attempts to identify the factors affecting Malaysia's economic growth; namely foreign debt, domestic debt, labor force, trade openness and savings as independent variables and to identify the existence of a bi-directional relationship between economic growth and government debt. Annual time series data over the period from 1987 to 2017 was analyzed using the Dynamic Ordinary Least Square approach. It was found that domestic debt has a positive and significant impact on economic growth. On the other hand, foreign debt has a negative and significant effect on economic growth. Other than that, there is no existence of a bi-directional relationship between economic growth and government debt. This study provides insights for policymakers and investors about the importance of better and quality debt management. Theoretically, it provides a fresh view of the literature that will promote more empirical research in the future. Future studies should extend the current study by considering other key factors that might significantly influence the level of economic growth.

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1. INTRODUCTION

For a nation to be developed, one of the common ways undertaken by the government is through debt or borrowings; also known as public debt or sovereign debt. Debt is a vital tool for a government in a country that would generate productivity and boost the economy. Government debt is defined as what a government borrows to make sure it can fund all its planned expenditures. In normal circumstances, the government will borrow money by supplying and issuing bonds or other securities. Amongst the economists, they would agree to say that certain government debt is not evil. For instance, during an economic downturn or even a recession where tax revenue decreases, money is needed by a government to save jobs and businesses. Then, a deficit is inevitable. A fiscal deficit, as scary as it may sound, is not so bad during good economic growth, is rewarded with a surplus. Hence, it balances out the government budget in the long run. According to Christen and Soguel (2019), higher debt can give an advantage to a government. They further state that when a decrease in the price of the borrowed capital is lower, then, there is the return rate in the capital markets. The government can benefit from this by issuing bonds and making investments using the gained capital on the capital market.

Why does the government borrow, one might ask? A borrowing is deemed more attractive to politicians to raise money rather than collecting more taxes. The purpose of borrowing varies from combating recession to public sector investment, war, and even political pressure since it is simply cheap to borrow. Furthermore, Daud (2016) argues that when the government debt rises to finance infrastructure investment, economic growth in a country will also increase because borrowing will help the rising of the supply side of the economy and enable higher economic growth. There will be higher tax revenues to pay back the debt if the growth is recovered, where the federal government debt accumulation gives a positive impact on the economic growth.

On the other hand, borrowing could lead a country to the bad side of government debt. For example, a competition between government bonds and corporate bonds for who can better attract investors causes interest rates to go higher. Whether the government or private sector should get more would just make one party would receive fewer investors' money than the other. But a great borrowing could create vulnerabilities as proven in the past. A country is more prone to a bad financial crisis if its debt-to-GDP ratio surpasses a certain level (Reinhart and Rogoff, 2009). A piling of debt comes without risk. The higher the debt level, the ability of borrowers to pay back is also critical. In some circumstances, defaulting is a possibility, as known to happen in a beautiful country, Greece. In 2020, its government debt-to-GDP is recorded at 205.60% (Hellenic Statistical Authority - National Statistical Service of Greece, 2021). As known to many, Greece was a troubled country due to economic mismanagement and its decision to enter Eurozone which put a strain further on the economy (Chartered Financial Analyst (CFA) Institute, 2017). Nevertheless, if a reasonable debt can be sustained by a small deficit, with the condition that GDP is increasing, accompanied by a higher level of economic growth, it is safe to take up more debt in the future.

1.1 Government Debt in Malaysia

As an open economy, Malaysia is prone to a financial shock. There are two significant events that have affected Malaysian economic growth. First, Asian Financial Crisis in 1997/98 originated from a massive drop in Thai Bath value. Despite its neighboring countries' act of borrowing to salvage their economies, Malaysia remained firm in not borrowing from International Monetary Fund (IMF). Next, in 2007/08, financial chaos spread worldwide from the US to the rest of the economy. The credit crisis deepened without sign of shrinking despite

interest rate cuts and enormous liquidity injections. Based on data by World Bank, from 2009 onwards, debt is recorded as high again for Malaysia and seen to be struggling to recover from the crisis. Debt is crucial for any country to aid its development when in crisis. Even though government borrowing has been recorded since as early as 1970, a sharp increase can be seen in the 1980s with the highest amount in history at 103.4% (debt-to-GDP ratio). This is the phase where economic reform was taking place and later brought growth to Malaysia. From 1986 until 1997, there was a bearish trend in government debt where it hit only 31.9%. While a fluctuation within 9.3% is seen from 1998 to 2008, none surpass 50%. However, for more than a decade from 2009, debt has never been recorded below 50% except in 2010 (49.6%). This clearly shows Malaysia was in trouble getting back on its feet after the 2007/08 financial crisis. Then, a sudden increase of 60.7% of debt-to-GDP occurred in 2020 where the recent pandemic of Covid-19 was obviously the reason behind this. Overall, an acceptable debt-to-GDP ratio was said to be not more than 60%, but a recent event has the government to change the debt threshold to 65%. An excessive national debt can impact the stability of an economy as everything in it is connected. Hence, how fast the government can react and make decisions on its fiscal problem will determine how damage to the economy can be minimized.

1.2 Problem Statement

A crucial way for a country to finance the development of its nation is by borrowing which would eventually generate productivity and boost the economy of a country. However, the increase in government debt may also lead to macroeconomic implications for the country and the occurrence of high debt can give a negative impact on the development of economic growth. Debt, if used correctly by a government would benefit the people where the standard of living can be improved. However, debt becomes bad if too much debt is being taken by a government to the point its ability to repay is questionable. As reported by Bank Negara Malaysia, as of 2021, the total debt held by the federal government amounts to RM979,814 million. The Gross Domestic Product in 2021 is reported at RM1,544,214 million which makes the debt-to-GDP ratio at 64.6%. Although the ratio is within the safe rate (65%), it should not be taken lightly as the Malaysian economic situation has been not improving since the 2010 world economic crisis.

The vulnerability of the Malaysian government accumulating high debt which has been publicly disclosed and educated is somewhere worrisome. By maintaining a sustainable economy, the government of Malaysia must execute and implement practical debt management strategies to moderate the impacts of the debt of the economy when the continuous rise in domestic and external debt of Malaysia occurs. Freeman and Webber (2009) stated that a government debt that is funded by major sectors such as education, healthcare, and nutrition should have a positive impact on economic growth. Therefore, this study is conducted to identify the factors affecting Malaysia's economic growth; namely foreign debt, domestic debt, labor force, trade openness and savings as independent variables for 30 years from 1987 to 2017. As most of the past studies focused on external (foreign) debt, domestic debt received less attention. Therefore, this variable is added to the model of this study. This study might provide insights to policymakers to remain concerned about the government debt by considering reforms to have a better and quality debt management and make it less prone to financial shocks. Also, it could aid investors as a guide in making decisions of investment. It provides a fresh view of the literature which could future researchers in their research endeavors.

2. LITERATURE REVIEW

2.1 Foreign Debt and Economic Growth

A mix of findings has been found in numerous studies regarding external debt's impact on economic growth. Makun (2021) explained three different situations that exist in discussing external (foreign) debt and economic growth; 1) debt-overhang, 2) liquidity constraint situation, and 3) direct effect of the debt situation. The first two situations have hypotheses and theories that were used by researchers in understanding the impact of debt growth. Both suggest that a higher debt level drives down economic growth due to an increase in government borrowing. Next, the direct effect of the debt situation shows enormous foreign debt which may reduce the existing capital productivity which in turn discourages the economic (Fosu, 1996). Meanwhile, some studies use all three situations to assess the impact on economic growth, this study will focus only on the direct effect.

Kharusi and Ada (2018) revealed a negative and significant influence of external debt on economic growth in Oman from 1990 to 2015. They investigated the relationship between government external borrowing and economic growth, prompted by the continuous increase in Oman’s external debt to finance its annual budget. Pegkas (2018) examined the Greek country from 1970 to 2016 where he focused on the effect of government debt and investment, private consumption, public consumption, trade openness and population growth on economic growth. He concluded there is a negative significant relationship between government debt-to-GDP and its growth. The results also indicated in the long run external, borrowing has a positive contribution to economic growth. The same result was found by Makun (2021) in Fiji between 1980 and 2018. Using the neoclassical growth framework and ARDL models, he looked for long-run linear and nonlinear associations among the variables: external debt, export and total factor productivity. As a result, in the long run, the linear measure of external debt has a negative significant effect on economic growth.

Anning et al. (2016) investigated the impact of government debt on the economic growth in Ghan, using simple Ordinary Least Squares from 1990 to 2015. They investigated the impact of government debt (both external and domestic) by testing three related models at the domestic and external levels including the general growth. It revealed a negative significant relationship between debt (domestic and external) and growth. It recommended among others that government debt borrowing should be discouraged while the revenue base is increased by encouraging tax reform programs. On the other hand, Matemilola et al. (2016) investigated the effects of public debt on the long-term economic growth of common law versus civil law countries in developing economies. The paper applied the Pooled Mean Group estimator that accounted for heterogeneity across countries by allowing the short-term coefficients to differ across countries but constrained the long-term coefficient to be identical. The results revealed that public debt lowers the long-run economic growth of common law countries, but it has insignificant effects on the long-run economic growth of civil law countries. Conversely, public debt has insignificant effects on the short-run economic growth of common law countries, but it lowered the short-run economic growth of civil law countries.

In Malaysia, Lee and Ng (2015) examined whether the public debt has contributed to the economic growth in Malaysia over the period 1991 to 2013. They also examined whether other indicators of debt burden, such as the budget deficit, budget expenditure, external debt service and government consumption, have an impact on economic growth. The results indicated that public debt over time has a negative and significant impact on GDP. Similarly, Daud et al. (2013) analyzed whether external debt contributes to Malaysia's economic growth in the long

run. By employing the Autoregressive Distributed Lag (ARDL) from 1991 to 2009, the study demonstrated the existence of a long-run relationship between external debt and GDP. In addition, the results also showed a consistent significant and positive relationship between external debt and Malaysia's economic growth for the sub-period analysis. The results substantiated the notion that the accumulation of external debt was associated with an improvement in Malaysia's economic growth up to a certain optimal point; above that level, an additional rise in external indebtedness contributed inversely to the Malaysian economy. This finding was consistent with Burhanudin et al. (2017), who found that government debt has a positive and significant effect on sustainable economic growth using the Autoregressive Distributed Lag approach from 1970 to 2015. There was also unidirectional causality running from government debt to sustainable economic growth. The findings indicated that Malaysia's government debt was an important macroeconomic element for the sustainability of economic growth in Malaysia.

2.2 Domestic Debt and Economic Growth

However, fewer studies were found on domestic debt. Domestic debt is where the debtor and creditor are to be within the same country. There were a few factors discussed to determine borrowing in a country such as the economic growth itself (Castro & Martins, 2020), the value of the collateral (Calza et al., 2013), loose monetary condition (Castro & Martins, 2020) and global factors (Araujo et al., 2017). Nevertheless, Avdjieva et al. (2021) in their study on 40 countries between 1980 and 2015 found that domestic borrowing will be more attractive if external bank lending in the form of bonds was offered. The same study also proved that credit busts were more likely to occur with a lower share of interbank lending and a higher share of lending from banks to non-banks. Furthermore, the authors also stated that external debt composition is a strong predictor of domestic credit cycle performance.

Additionally, Daud (2016) analyzed data from 1970 to 2012 for Malaysia and found a positive and significant result between federal government debt (when it reached maximum level) and economic growth. The result from this study also demonstrated a long-run relationship between federal government debt and economic growth, any amount beyond that would cause a negative relationship. Moreover, a study done by Spilioti and Vamvoukas (2015), showed the results supported the existence of a statistically positive significant relationship between domestic debt and GDP growth using Greek data for about 40 years starting in 1970, taking into consideration the different levels of economic growth in Greece during the examined period. The results suggested that key independent variables such as government debt, the gross domestic per head of population, and the gross national savings represent the important determinants of the growth rate of gross domestic product. In addition, Ibrahim and Khan (2019) indicated in their research that domestic debt has a positive effect on the economic growth in Nigeria from 1981 to 2013 which was highly contributed by a reformation in its financial system.

2.3 Labour Force and Economic Growth

Labour is one of the essential factors of production that contributes to economic development. Many issues have been discussed on the labor force over the decades, including its impact on economic growth (Amir et al., 2015), the importance of the female labor force, minimum wage (Maareka & Moiteaux, 2021), aging (Ribeiro, 2019), and immigrant labor (Azlor et al., 2020). According to Young (2018), a country with an increasing labor force population would help the economy to boost the productivity of its production. A study by Young (2018) examined the impact of labor force dynamics on economic growth in Nigeria from 1970 to 2015, using the newly developed bounds testing approach to co-integration. He found both have significant