Center for Market Education

CME Policy Paper No 3
August 2021

Inflation, Unemployment and COVID-19 Policies: Where Is The Malaysian Economy Heading?

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Executive Summary

In the present paper we critically analyzed the fiscal and monetary policies implemented to help Malaysia navigating through the COVID-19 pandemic, focusing on their unintended consequences and the pace they set for the future of the national economy.

The first part of the paper presents a summary of the different fiscal and monetary policies implemented during the COVID-19 era, focusing on the current trends for GDP, unemployment and inflation.

The second part, instead, places that measures under the lens of a theoretical economic analysis, to stress the unintended consequences they produced and the perilous path they created for the future of the Malaysian economy.

We know that the Malaysian GDP declined by 5.6% in 2020 amid the harsh economic restrictions imposed in the attempt to curb the spread of COVID-19. Stay-at-home orders increased unemployment up to 5.3% and forced the government to intervene with different stimulus packages, supported by expansive policies by Bank Negara Malaysia.

The main critically findings from the theoretical analysis can be summarized as it follows:

- The expansive monetary policy path followed by Bank Negara Malaysia, by creating abundant availability of financial means despite the recession, is creating a dichotomy between the financial world and the real economy, planting the seeds for an economic crisis (monetary cycle à-la Mises).
- Expansive fiscal policies implemented to address the damages created by stay-at-home orders may result in temporary effects, but will 1) shift the debt burden to future generations and 2) create more unemployment when the stimuli are over.
- Most of the same fiscal policies can generate a slower future growth path by decelerating the pace of private investments.

Therefore, the policies implemented so far may become the very root of an economic crisis once the COVID-19 emergency is over and the economy is on the path to recovery. Their effects on inflation and unemployment will become more evident when the deflationary pressures currently in play will be no longer in place.

We foresee unemployment to be between 5% and 5.5% at the end of 2021, depending on when lockdowns will be lifted and a serious discussion on domestic and international borders will be opened. The figure could stabilize between 4% and 4.5% if the current trend in business openings won't be stopped by further closures.

In accordance with Fitch's predictions, we foresee a flat growth for 2021, with the possibility of an annual rebound between 1% and 2% only in case of a rapid and radical change in policies.

The paper suggests that at this point it is very difficult to propose solutions to problems that were created by policies (lockdowns) judged harmful in light of a sound trade-off analysis. We can now attempt to moderate those negative consequences.

A commitment to a no-lockdown policy would help the system naturally free up resources to be invested consistently with the real structure of preferences, while the government should focus on targeted healthcare investments. Targeted fiscal interventions, directed to strengthen the healthcare system, are the only fiscal tool that in this moment may not produce bad unintended consequences in the future in terms of slower growth, inflation and additional unemployment. Similarly, monetary policy will need to change in order to allow deflationary tendencies to run their course.

Finally, a tax reform, which is based on simplification on one hand and on the introduction of a multi-layered GST (consumption tax) on the other, would favour rebuilding the savings which are necessary not only for the long-term financial stability of households, but also as the sound resources for private investments.

Part 1

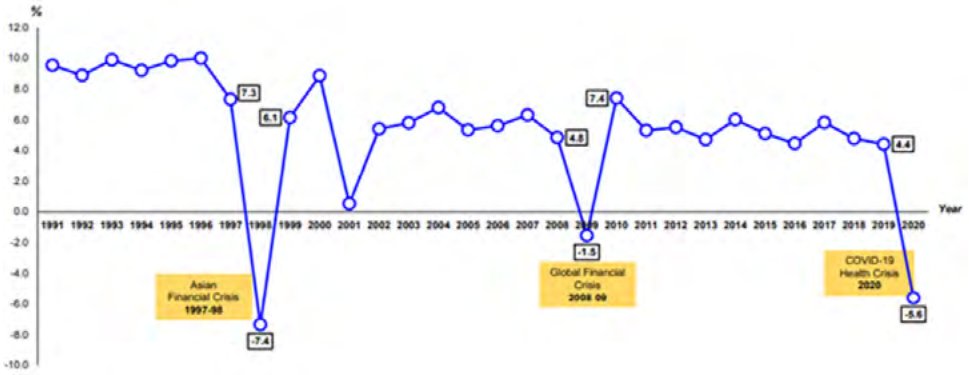
The Malaysian Economy In The Covid-19 Era: Key Indicators And Policy Summary

I.1. Introduction: The current status of the Malaysian economy

The unforeseen outbreak of COVID-19 has caused a damaging shock in Malaysia since early 2020, mostly because the country and the whole world seemed to be unprepared to face such a health crisis. At the same time, political instability is undermining the government's competency in tackling the pandemic and to take decisions based on a sound trade-off analysis. As a result, the virus, together with the subsequent series of lockdowns and border closures, have taken a massive toll on the Malaysian economy and livelihoods (which, ultimately, are lives).

Before COVID-19, the annual Malaysian gross domestic product (GDP) figures were RM1.36 trillion and RM1.42 trillion in 2018 and 2019, respectively, at constant 2015 prices. The annual GDP growth was 4.8 percent in 2018 and 4.4 percent in 2019. Due to the outbreak, the annual Malaysian GDP was RM1.34 trillion in 2020, where the annual GDP growth was -5.6 percent, the lowest since the Asian Financial Crisis in 1998 (DOSM, 2021a).

Figure 1: Annual Percentage Change in Malaysia's GDP at Constant Prices.



Source: DOSM (2021a).

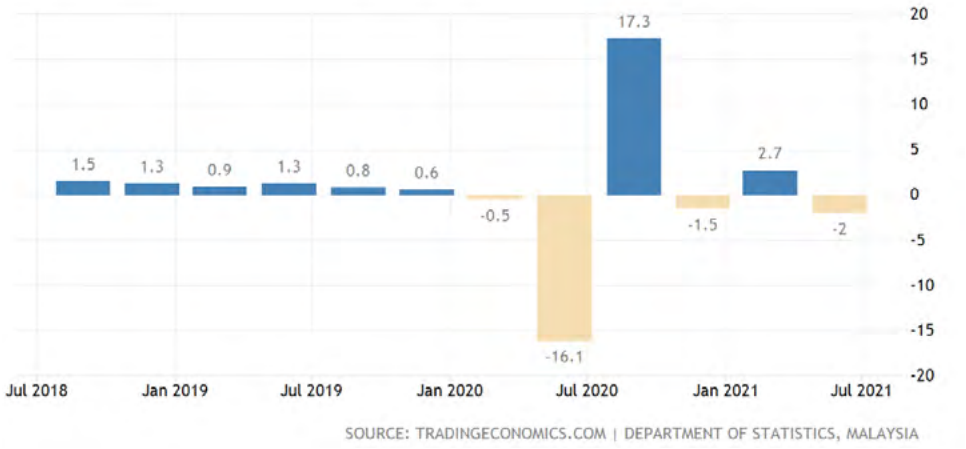
As for quarterly GDP, Malaysia had a steady year-on-year (YOY) growth between 4.5 and 5.0 percent in 2018 and 2019. The decline in economic growth began in the final quarter of 2019, and after the virus outbreak, Malaysia began experiencing negative YOY growth, with the second quarter of 2020 having the worst figure, which was -17.2 percent (DOSM, 2021b). At first, the year 2021 seemed to be promising as the latest data shows a small YOY decrease of 0.5 percent in the first quarter, but the continuation of lockdowns in Malaysia further dampens any expectation for economic rebound.

In fact, while the early GDP growth in Q2-2021 was a spectacular 16.1%, ending a year of negative performances, the reason for such growth needs to be found mostly in the very low reference base (-17.2% in Q2-2020) and cannot be confused as a signal of a sound recovery ahead. In fact, when compared with Q1-2021, GDP declined by 2%, putting the quarterly performance again in negative territory after the positive signs showed in Q1-2021.

Figure 2: Malaysia's GDP annual growth by quarter, 2018-2021.

Source: https://tradingeconomics.com/malaysia/gdp-growth-annual.

Figure 3: Malaysia's GDP quarterly growth, 2018-2021.



Source: https://tradingeconomics.com/malaysia/gdp-growth.

The new full lockdown imposed nationwide since the beginning of June not only is not bringing benefits from a healthcare perspective, but is heavily weighing on the economy, threatening business survival and possibilities for individuals to make ends meet, particularly in Kuala Lumpur and Selangor. As shown in the table below, in fact, it is precisely since June that the national economy started to suffer again and re-entered negative territory.

Figure 4: Malaysia's real GDP growth, 2021.

Month	% yoy
January	-3.6
February	-3.6
March	6.1
April	40.1
May	19.8
June	-4.4

Source: BNM (2021a, p. 2).

[4] *Salk (2021) and Lei et al. (2021).x*

In a nutshell, if we make Q2-2021 GDP = 100, it went down to 82.8 in Q2-2020 (100-17.2) and it is currently at 96.13 (82.8 + 16.1%), which means it is still 3.87% lower than what it was before the pandemic. Unfortunately, the prolonged and extensive lockdown implemented in June 2021 leads us to believe that the outlook could even worsen (our projections are presented later in the paper).

In the next sections we will analyse the different fiscal policies implemented by the Malaysian government to address the problems created by the various stay-at-home orders. Similarly, we will see what has been done from a monetary perspective and the effects they have had on the level of prices and employment. After these analyses, we will critically discuss the potential negative long-term consequences produced by such policies, concluding with our short-term outlook and recommendations.

I.2. Economic stimulus packages and fiscal policy

The GDP figures noted above may underestimate the true impacts of COVID-19 and hide the potential unintended consequences described in the next sections. From an expenditure approach, most components show negative growth in 2020, except government spending. For instance, at constant prices private consumption, which made up 59.5 percent of annual Malaysian GDP in 2020, declined by -4.7 percent, but government expenditure rose by 4.2 percent (DOSM, 2021a). The expansion in government expense could be explained by the initiatives to tackle COVID-19, including health expenditures and economic assistance (MOF, 2020d).

Photo by Izuddin Helmi Adnan on Unsplash

In fact, the Malaysian government incurred an exorbitant amount of spending in 2020 and 2021 in effort to reduce economic consequences caused by lockdowns which, in turn, were implemented in an attempt (since proven wrong) to curb the spread of COVID-19. The huge fiscal effort is a typical example of a later policy (stimulus packages) trying to address the negative unintended consequences produced by an earlier policy (lockdowns). As explained by Coyne and Boettke (2020, p. 51):

> «In response to these unintended consequences, policymakers have two options. They can remove the initial intervention, which will free the market process to operate without distortions. Alternatively, they can introduce additional policies meant to address these undesirable outcomes. But notice that this second course of action requires expanding the discretionary power of policymakers as they extend their control over additional aspects of economic activity»

However, as we have seen in Malaysia with the recourse to emergency powers and the suspension of the Parliament, in order to continue pursuing such a course of action, the government needs to further curb liberties and increase its discretionary powers.

> «In order to design, implement, and enforce an initial intervention, government planners need some scope of discretionary power. Policymakers need to be able to impose rules on private persons engaged in voluntary exchange in order to get the desired outcome, which differs from what would have otherwise emerged. Moreover, policymakers must be able to enforce the rules imposed to ensure compliance and to punish deviations. Now, consider what happens when the initial intervention results in unintended consequences and planners choose to impose additional rules in the hopes of addressing these undesirable outcomes. Policymakers must expand the scope of their power to intervene in other areas of economic activity. As the dynamics of interventionism suggest, even what appears to be simple interventions into the market can have a chain of consequences that require subsequent interventions. When this happens the discretionary power of government policymakers expands as planners require additional control and influence to address the new, and unanticipated, consequences of prior interventions»
>
> (Coyne and Boettke, 2020, p. 51).

This is not the place to discuss the worsening political scenario in Malaysia. Instead, we will look at the different fiscal measures implemented by the Malaysian government in an attempt to counter-act the negative consequences produced by lockdowns. As of December 2020, the government's relief packages rose to 23 percent of Malaysian GDP (Nambiar, 2021). Based on LAKSANA reports and government announcements, the total amount of allocations for economic stimulus packages to date is about half a trillion ringgit (IDEAS, 2021).

The allocations include additional spending as well as foregone and delayed revenue, meaning that this country is distressing its financial capacities. According to a dataset on federal COVID-19 economic stimulus packages, so far the total additional expenditure incurred is RM148.3 billion (29 percent), the total foregone revenue is RM47.5 billion (9 percent), the liquidity provision and capital injection are RM23.3 billion (4 percent), the total loan guarantees are RM75.0 billion (14 percent), and the total deferral of bills and loans is RM223.9 billion (43 percent) (IDEAS, 2021).

The federal government is the main source of these allocations, but agencies and private sectors also contribute their share. For example, in total the fully government-sourced allocation amounts to RM83.2 billion, while private sectors incurred about RM137.1 billion for the stimulus packages. Public agencies bear the most amount thus far, which is RM192.6 billion or 37.2 percent of the whole set of initiatives. Certainly, some costs are jointly borne, such as all collaborative initiatives between the government and private sectors, which are about RM2.84 billion (IDEAS, 2021).

Additional expenditures that impact federal spending are covered mostly by the government itself (RM74.4 billion), with some funding coming from public agencies (RM52.8 billion). Costs of deferrals are mainly borne by private sectors (RM132.6 billion), with some jointly shared with public agencies (RM80 billion). As briefly shown above, deferrals also make up the largest percentage of the stimulus packages, which are about 43 percent (IDEAS, 2021). Other than that, the foregone revenue, the liquidity provision, and the loan guarantees are primarily backed by government agencies.

In terms of objectives, the economic stimulus packages aim to achieve four main purposes, which are combating COVID-19 and strengthening healthcare, safeguarding individual and household welfare, supporting businesses, and recovering the economy. Note that the following allocations are based on information that is available, meaning that some data are still undisclosed, thus the total allocations may not amount to the true value.

Based on available data, the estimated allocation for healthcare and fighting Covid-19 is RM9.7 billion, with RM5.6 billion allocated for all vaccination matters. For recovering the overall economy, about RM4.9 billion is allocated. In an effort to support businesses, the estimated allocation is RM156.8 billion, with about RM4.4 billion specifically provided for SMEs. For supporting individual and household welfare, RM124.2 billion is allocated, RM8.7 million of which is extra funding for B40 initiatives. Some assistance can be for both households and businesses. Hence, for these, the estimated allocation is about RM215.2 billion (IDEAS, 2021).

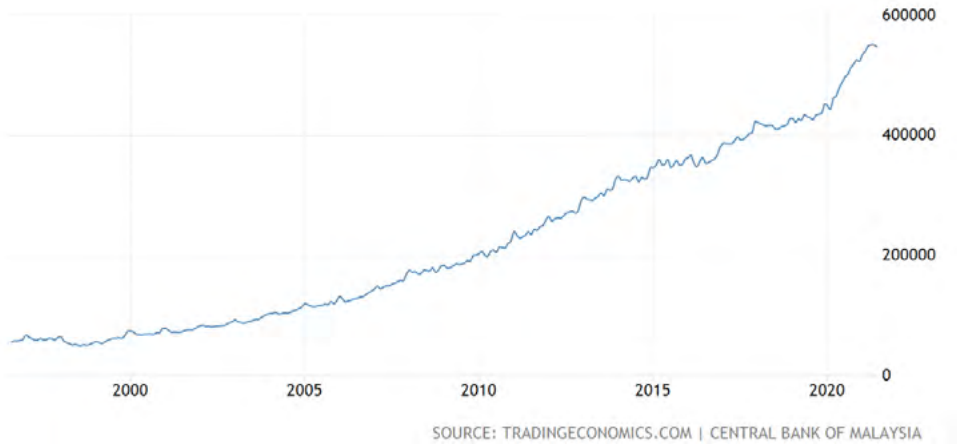
In 2019, the Malaysian fiscal deficit was 3.4 percent of GDP (Wong, 2020). During the pandemic, the country reached a fiscal deficit of 6.2 percent of GDP in 2020 (Bernama, 2021a). For 2021, the Ministry of Finance (MOF) has increased the fiscal deficit forecast further from 6 percent to between 6.5 and 7 percent of GDP (Bernama, 2021b). This new prediction figure is as high as the largest deficit recorded in Malaysia, which was 6.7 percent in 2009 following the global financial crisis (MOF, 2020a).

Government revenue collection is also impacted by the health crisis. In 2019, the recorded total government revenue was RM264.4 billion (17.5 percent of GDP), 68.3 percent of which came from tax collection. For 2020, the latest estimate of government revenue was RM227.3 billion (15.8 percent of GDP), with -14.0 percent growth, 67.4 percent of which was tax revenue (MOF, 2020b). Based on the Federal Budget 2021, the forecast for 2021 revenue is optimistic, stating that government coffers will grow by 4.2 percent to RM236.9 billion, but this forecast did not take into account the lockdowns enforced in 2021 (MOF, 2020c). The fact that the fiscal deficit forecast is revised again means that this series of lockdowns should also affect government revenue collection in 2021.

1.3. Monetary policy and inflation

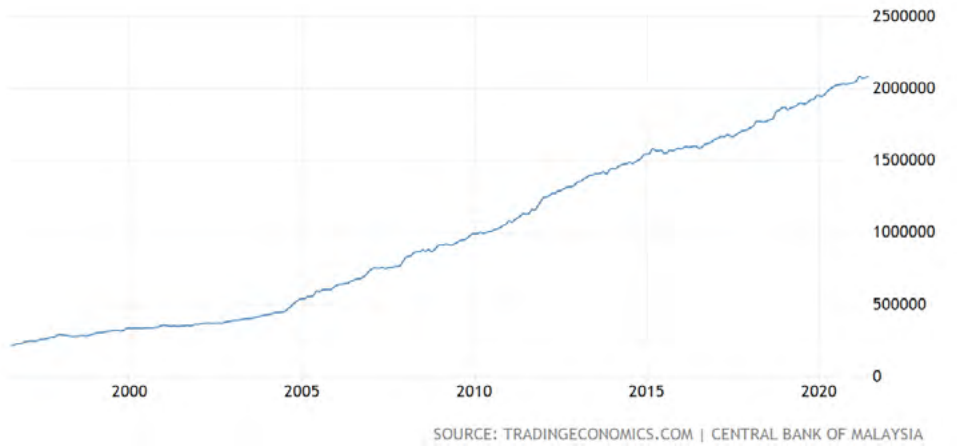
The government's fiscal action was supported by Bank Negara Malaysia's (BNM) extremely supportive monetary policy. The level of monetary expansion is shown by the dynamics in the main aggregates, M1 and M2.

Figure 5: Malaysia money supply M1, 1995-2021.



Source: https://tradingeconomics.com/malaysia/money-supply-m1.

Figure 6: Malaysia money supply M2, 1995-2021.



Source: https://tradingeconomics.com/malaysia/money-supply-m2.

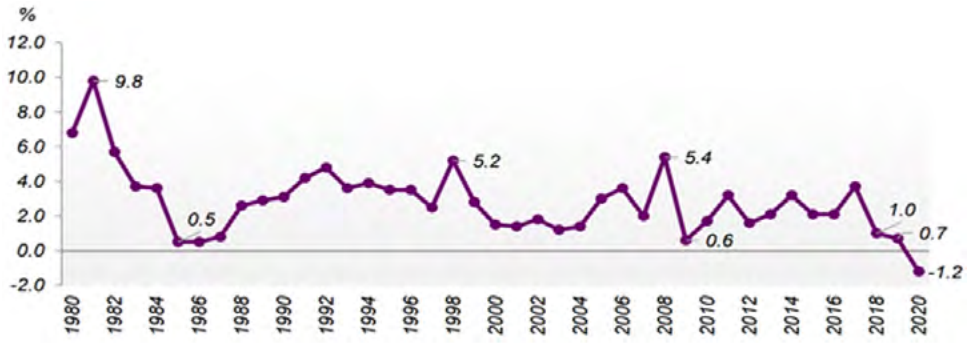
Similarly, Bank Negara adopted an expansive approach with regard to the reference interest rate, which reached record low levels, standing currently at 1.75%.

Figure 7: Malaysia interest rate, 2005-2021.

Source: https://tradingeconomics.com/malaysia/interest-rate.

The effects of these expansions, together with supply-side shocks created by disruption in the global supply chain, are starting to be reflected in price dynamics. Before COVID-19, the Malaysian annual inflation rate had been quite steady at between 0 and 4 percent in the past decade (2010-2020). However, in the same period, household purchasing power had shown a decline of 16.7 percent. Then, in 2020, when the COVID-19 pandemic occurred, the annual inflation rate was at its lowest level for the first time in four decades at -1.2 percent (DOSM, 2021c). This situation is unlike the 1997 Asian Financial Crisis and the Global Economic Recession 2008, when inflation rates were higher than average.

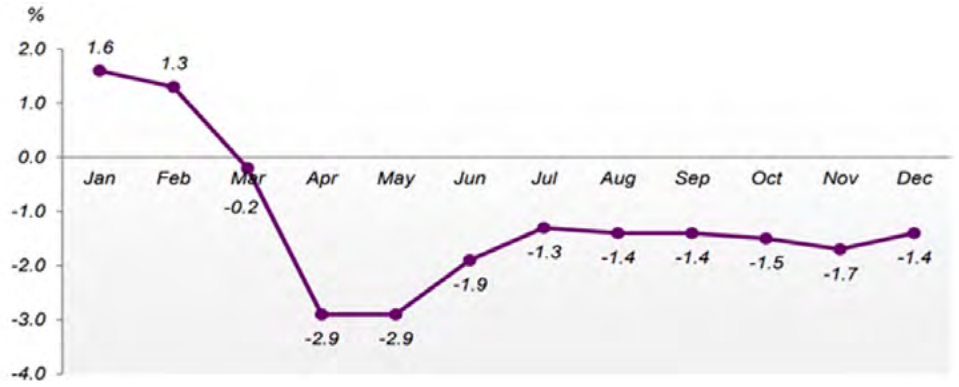
Figure 8: Annual Headline Inflation in Malaysia, 1980-2020.



Source: DOSM (2021c).

The core inflation rate stayed at 1.1 percent for both the years 2019 and 2020. Viewed by month, the inflation rate began recording negative figures from March to December 2020, which was precisely the period of the Movement Control Order (MCO) last year (DOSM, 2021c). One explanation for this is the reduction in the price of petrol and diesel per litre by the government in 2020, and at the same time the fall in oil prices due to the decline in demand for oil last year. Besides that, there were decreases in prices of housing and utilities due to the discount initiatives for domestic consumption announced by the Malaysian government.

Figure 9: Monthly Inflation in Malaysia, 2020.



Source: DOSM (2021c).

In 2021, the monthly inflation rates began recording positive figures again since February, mostly due to the lower base effects from previous months and last year as a result of lower fuel prices for private vehicles (DOSM, 2021d). Transportation was the biggest contributor to the increase in inflation in the first half of 2021. The highest figure in April 2021 was also mainly driven by increases in indices of transportation, utilities, and food and non-alcoholic beverages. However, the implementation of MCO 3.0 and operational closures for non-essential sectors have caused slower momentum of inflation pressures.

Particularly significant is the jump recorded in the past year in the producer price index, which is mainly due to international movement restrictions and supply chain disruptions.

Figure 10: Malaysia producer price index, 2015-2021.

Source: https://tradingeconomics.com/malaysia/producer-prices.

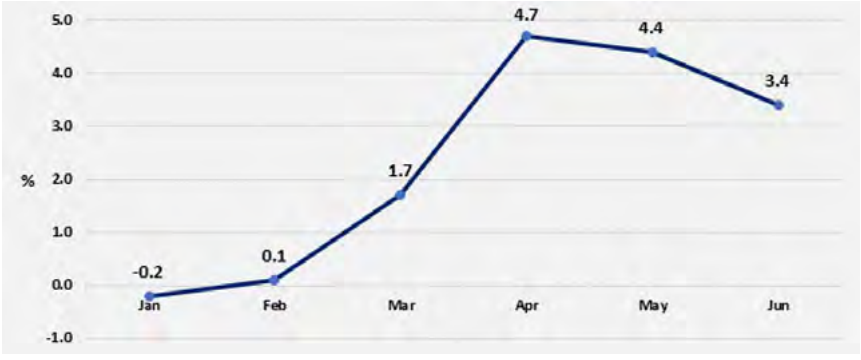
Those price tensions are now reflected in the consumer price index.

Figure 11: Malaysia consumer price index, 2015-2021.

Source: https://tradingeconomics.com/malaysia/consumer-price-index-cpi.

Malaysia's monthly inflation is reported in the graph below.

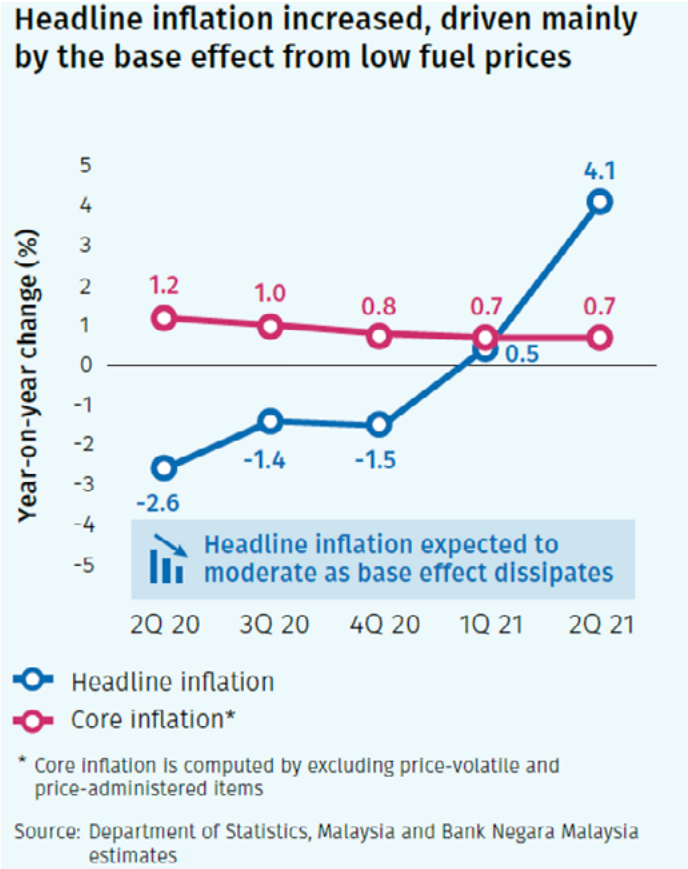
Figure 12: Monthly Inflation in Malaysia, 2021.



Source: DOSM (2021d).

According to BNM, the trend is not a source of concern because it is mainly driven by non-core inflation, but later in the paper we will see its potential negative consequences.

Figure 13: Core and headline inflation in Malaysia, 2020-2021.



Source: BNM (2021b, p. 6).

1.4. Unemployment, underemployment and poverty

Unfortunately, the massive fiscal and monetary interventions have not impeded the employment, underemployment and poverty situation in the country from worsening.

Malaysia has a different look to poverty based on the DOSM *Household Income Estimates and Incidence of Poverty Report 2020* (DOSM, 2021f), published on 6 August 2021. The country displayed an increase in absolute poverty from 5.6% in 2019 to 8.4% in 2020. This has led to an increase of 234,400 poor households from 405,400 households (2019) to 639,800 households (2020).

Photo by Boudewijn Huysmans on Unsplash

Hardcore poverty is estimated to increase from 0.4% in 2019 to 1.0% in 2020, amounting up to 78,000 households. Meanwhile the 2019 survey report stated that relative poverty increased to 16.9% in 2019 (1.2 million households having a monthly income of RM3,000), which is less than half of the overall intermediate income of RM5,873. The poverty rate is however still underestimated as there are more people living in poverty than the data account for.

The country revised its poverty line income (PLI) in July 2020, set at RM2,208 from the previous RM908 per month. The methodology by DOSM categorised the PLI for households based on non-food items (RM1,038) and food (RM1,169). With the DOSM 2020 report and the pandemic crisis, more poor households are living with monthly incomes below the poverty line and are in a state of poverty. Their income is insufficient to sustain necessities such as food, shelter, and clothing. The recent report stated that an additional 12.5% of households are living with income less than RM2,500. The decline in income has shifted households to lower income groups, from T20 to M40 and M40 to B40. The result of a larger percentage decrease in income for B40 and M40 than the T20 has reduced the income distribution for B40 and M40.

Consumption patterns of Malaysians change from time to time, and they vary across different income groups. With technology rising over time and digitalisation being the focus, spending will increase on items such as communication and internet connections. This magnifies the trend of spending on items once described as discretionary. Other than that, the spending trend for non-food

items among B40 households is more than 60% of their total expenditure, as reported in DOSM 2019 expenditure survey data (DOSM, 2020).

The United Nations Children's Emergency Fund (UNICEF) report *Families on the Edge* in December 2020 described that the poverty rate during the time of the survey was at 43%, displaying even higher rates of 55% among persons with disabilities and 61% among female-headed households (2021). This is a result of the MCOs amid the pandemic crisis for families with low-income levels in urban areas (UNICEF, 2021).

According to the national 2021 budget, a sum of RM2.2 billion has been allocated to help poor families and individuals on a monthly basis through Bantuan Prihatin Nasional (BPN) (MOF, 2020c). However, not everyone will receive this allocation as more are falling into poverty and experiencing loss of income during the pandemic. Also, the IDEAS comparison dataset presented that there are allocations to assist the poor amid the pandemic in initiatives such as PRIHATIN, PRIHATIN+, KITA PRHATIN, PERMAI, PENJANA, PEMERKASA, and PEMULIH.

As exhibited in the DOSM report, the unemployment rate in Malaysia eased to 4.5% in May 2021 compared to 4.6% in April 2021; however, it further rose to 4.8% in June. The total number of unemployed persons stood at 768,700 in June 2021. In May 2020, the unemployment rate was recorded at 5.3%, and the number of unemployed persons was 826,100 persons. There was a drop of 98,000 unemployed persons (11.9%) in a one-year period (DOSM, 2021e), but in June 40,100 more were added. The resurgence of COVID-19 and the expiration of economic stimulus incentives may contribute to an uncertain unemployment trend. If mid-size or large companies are not qualified for any relief measures and continue to run with low profits, they may downsize or eventually shut down, thus contributing to the increase in unemployment. We expect inflation to fix around 5 to 5.5% by the end of 2021, depending on when lockdowns will be lifted.

It is expected that time-related underemployment was higher in Q1-2020 since the enforcement of the MCO. Businesses were restricted to economic activities. DOSM reported a decrease of 0.5% in time-related underemployment from 2.5% (Q1-2020) to 2.0% (Q1-2021). It was informed that businesses were able to resume operation as the SOPs were relaxed, business operating hours were extended, and economic activity began to pick up.

Conversely, skill-related underemployment increased to 37.5% (Q1-2021) from 36.2% (Q1-2020), with a total percentage increase of 1.3%. This is believed to be due to tertiary education graduates taking jobs that do not match their skills, so they are working in semi-skilled and low-skilled jobs. In other words, there are mismatches between skills required and the job positions available in the market. A person with high educational attainment or skill is working in a low-paying or low-skilled job. These concerns existed prior to the coronavirus; it is a structural issue in the labour market and education system.

Besides, the rise of the gig economy during the pandemic and the existing lack in skills also contribute to the economic structural changes in skilled-related and time-related underemployment. Realising that, the government has introduced a few measures to help underutilised workers and workers with less disposable income. The reskilling and upskilling programmes are targeted to tackle the structural changes in the labour market. This approach should not only focus on existing underemployed and retrenched workers but also new graduates, since educational attainment is still mismatched with highly demanded industrial skills.

To curb the challenges, the 2021 budget allocated RM3.7 billion through JanaKerja, such as the short-term employment programme and employment recruitment incentives programme, to help create new job opportunities (MOF, 2020c). Due to the pandemic other initiatives were introduced to tackle unemployment, such as PRIHATIN, PERMAI, PENJANA, PEMERKASA, and PEMULIH.

Part II Policies Have Consequences: The Scenario Ahead

II.1 The unintended consequences of monetary policy

As suggested by most macroeconomics textbooks, the Malaysian Central Bank adopted an expansive fiscal policy in an attempt to limit the damages from stay-at-home orders and to help reviving the economy. The extent of these moves was described earlier in this paper, with a close eye on inflation. While a growing number of economists are sceptical about recognising the eventual stimulus role played by cuts in the interest rate, and some of them believe that such a measure is key in generating boom and bust cycles, the first question to be posed is: are we trusting monetary policy too much? (Ferlito, 2020).

Indeed, if it worked perfectly as described by textbooks — lower the rate to stimulate the economy and raise it to cool down prices — monetary policy would be an easy tool, and we would not experience economic crises. In fact, central bank actions are based on past information (and information always evolves), and it takes time for such actions to produce effects (and the bigger the time lag, the bigger the evolution of the context).

It is important to understand that monetary policy is a signal more than an objective fact. By lowering the interest rate, the central bank wishes to communicate that more financial resources have been made available for investment (or that borrowing money is cheaper).

However, as economists such as Friedrich Hayek, Ludwig Lachmann and Don Lavoie have taught us, economic reality is not shaped merely by facts; what counts more is the way in which economic agents interpret the signals generated by objective facts. Prices, for example, are objective figures, but purchasing decisions are taken by consumers according to how they interpret those figures.

The objective fact here is the interest rate cut. One potential interpretation is that more financial resources are available — or that "money is cheaper" — and this would eventually call for more investment (which may be also malinvestment). However, this is not the only possible interpretation. Market players may think that the central bank is worried about the present status of the economy and therefore may become even more conservative and hold back. In a nutshell, the economy is made by billions of individual actions linked by signal interpretations; in such a system, nothing is automatic, and the result of an action is open-ended by nature.

The second point is tightly linked to the first one. The underlying question is still the same: do we trust monetary policy too much? When we believe that the interest rate is the main driver for investment, we are disregarding the basic fact that entrepreneurial decisions are mainly driven by profit expectations. It is enough to look at the mixed results produced by quantitative easing in Europe: if businesspeople do not expect a bright future, no matter how low the interest rate is, they simply do not invest.

There is more, though. In fact, expansive monetary policies may be at the root of economic fluctuations. Ferlito (2013, 2014, 2016) explained that there are fundamentally two different types of economic crises, or business cycles: the monetary cycle and the natural cycle. The monetary cycle is characterized by malinvestments generated by the artificial creation of credit; these fluctuations are typically set in motion by monetary policy. On the other side, what is called the natural cycle is the normal progression of the capitalist system through different waves, associated with rising profit expectations and often with what Schumpeter called 'new combinations' (new products, new technologies, new markets, new raw materials or new market organizations). While certain economic crises are typically associated with the monetary cycle, like in the case of the Great Recession (2007 till now), others arise instead as natural cycles but can be overextended by monetary manipulation intervention, so that they are a mix of the two different cycles; the "dot com" crisis (2001) and the Malaysian property market bubble,

whose expansionary stage dates between 2008 and 2013 (Ferlito, 2018), are examples of mixed cycles.

We believe that the monetary policy adopted by Bank Negara Malaysia (BNM) is contributing to drive the Malaysian economic system toward a monetary cycle. As we have seen in the previous sections, BNM's response to the lockdown crisis has been lowering the interest rate to historically low levels.

As mentioned, expansionary monetary policies can be the driver for a boom-and-bust cycle. Ludwig von Mises (1912, 1936, 1949), who focused exclusively on a monetary approach to business cycles, explained that the first cause of the cyclical trend is the over-expansion of credit, that may take the shape of an interest rate kept artificially low or the direct issue of money and its substitutes (we saw above the growth in M1). In particular, cheap money encourages economic initiatives that, under normal conditions, would not be judged viable. An economic system based on chance comes to the fore.

> «The lowering of the rate of interest stimulates economic activity. Projects which would not have been thought "profitable" if the rate of interest had not been influenced by the manipulations of the banks, and which, therefore, would not have been undertaken, are nevertheless found "profitable" and can be initiated. The more active state of business leads to increased demand for production materials and for labour. The prices of the means of production and the wages of labour rise, and the increase in wages leads, in turn, to an increase in prices of consumption goods. If the banks were to refrain from any further extension of credit and limited themselves to what they had already done, the boom would rapidly halt. But the banks do not deflect from their course of action; they continue to expand credit on a larger and larger scale, and prices and wages correspondingly continue to rise» (Mises, 1936, pp. 28-29).

As we have seen, inflationary pressures are already in motion and the effect on wages may appear when the COVID-19 crisis is over and the economy back on track. This inflationary movement cannot continue indefinitely, since monetary means have expanded but not the means of production and labour.

> «Society is not sufficiently rich to permit the creation of new enterprises without taking anything away from other enterprises. As long as the expansion of credit is continued this will not be noticed, but this extension cannot be pushed indefinitely. For if an attempt were made to prevent the sudden halt of the upward movement (and the collapse of prices which would result) by creating more and more credit, a continuous and even more rapid increase of prices would result. But the inflation and the boom can continue smoothly only as long as the public thinks that the upward movement of prices will stop in the near future. As soon as public opinion becomes aware that there is no reason to expect an end to the inflation, and that prices will continue to rise, panic sets in. No one wants to keep his money; because its possession implies greater and greater losses from one day to the next; everyone rushes to exchange money for goods, people buy things they have no considerable use for without even considering the price, just in order to get rid of the money» (Mises, 1936, pp. 29-30).

As a consequence, product prices increase disproportionately.

> «If, on the contrary, the banks decided to halt the expansion of credit in time to prevent the collapse of the currency and if a brake is thus put on the boom, it will quickly be seen that the false impression of "profitability" created by the credit expansion has led to unjustified investments. Many enterprises or business endeavours which had been launched thanks to the artificial lowering of the interest rate, and which had been sustained thanks to the equally artificial increase of prices, no longer appear profitable. Some enterprises cut back their scale of operation, others close down or fail. Prices collapse; crisis and depression follow the boom. The crisis and the ensuing period of depression are the culmination of the period of unjustified investment brought about by the extension of credit. The projects which owe their existence to the fact that they once appeared "profitable" in the artificial conditions created on the market by the extension of credit and the increase in prices which resulted from it, have ceased to be "profitable". The capital invested in these enterprises is lost to the extent that it is locked in. The economy must adapt itself to these losses and to the situation that they bring about. In this case the thing to do, first of all, is to curtail consumption and, by economizing, to build up new capital funds in order to make the productive apparatus conform to the actual wants and not to artificial wants which could never be manifested and considered as real except as a consequence of the false calculation of "profitability" based on the extension of credit» (Mises, 1936, pp. 30-31).

In this scenario, it would be important to stimulate the accumulation of savings, rather than further trying to stimulate aggregate demand. Further reducing the interest rate would cause more harm than utility (Hayek, 1929, pp. 21-22); surely, it cannot stimulate the economy.

> «Once the reversal of the trade cycle sets in following the change in banking policy, it becomes very difficult to obtain loans because of the general restriction of credit. The rate of interest consequently rises very rapidly as a result of a sudden panic. Presently it will fall again. It is a well-known phenomenon, indeed, that in a period of depressions a very low rate of interest-considered from the arithmetical point of view-does not succeed in stimulating economic activity. The cash reserves of individuals and of banks grow; liquid funds accumulate, yet the depression continues.
> […]
> Finally, it will be necessary to understand that the attempts to artificially lower the rate of interest which arises on the market, through an expansion of credit, can only produce temporary results, and that the initial recovery will be followed by a deeper decline which will manifest itself as a complete stagnation of commercial and industrial activity The economy will not be able to develop harmoniously and smoothly unless all artificial measures that interfere with the level of prices, wages, and interest rates, as determined by the free play of economic forces, are renounced once and for all. It is not the task of the banks to remedy the consequences of the scarcity of capital or the effects of wrong economic policy by extension of credit» (Mises, 1936, pp. 32-35).

How is it possible that interest rate manipulation can generate such disastrous consequences for the economic system? This is because the interest rate defined by the monetary authorities (the monetary interest rate) is not the one that would arise in the market from the free interaction of supply and demand (the natural interest rate) and that is a measure of the intertemporal structure of preferences, which in turn is matched by a production structure, i.e. a heterogeneous set of combinations of capital goods, organized by human creative and entrepreneurial action in order

to carry out processes that, over time, generate an output. This output should meet a demand defined by the structure of time preferences. This structure is reflected in an interest rate that, in turn, expresses the magnitude of the preference of economic agents for present goods compared to future goods.

In the scenario described by Mises, the central authorities cut the monetary rate in the belief that lowering the interest rate sets in motion an expansion cycle without negative repercussions. In such a scenario, the central bank is misleading the profit expectations of entrepreneurs, wrongly informing them that new resources are available for investments. Therefore, entrepreneurs consider it advantageous to invest in new investment projects. Entrepreneurs, following the interest rate manipulation, become more future-oriented, although more savings are not generated; consequently, available resources are fictitious and time preferences are changed unilaterally, leading to a disequilibrium in intertemporal preferences: future-oriented investors and present-oriented consumers (or not as future-oriented as entrepreneurs). A change in time preferences always happens unilaterally, but when only the natural interest rate plays a role this change can be communicated to the other side of the market.

At the peak of the artificial boom, the economy is unable to sustain production oriented over and above its possibilities. Sooner or later, people understand that an increase in wages is nullified by growing inflation. In addition, demand for capital goods runs out, taking with it the over-production in the particular sector, and it is here that problems arise. Many economic initiatives set up through excessive reliance on credit cannot be completed, although the debts still must be paid. Many companies must be expelled from the system; capital is scarce and banks raise interest rates. A period of adjustment and return to equilibrium begins, only it takes the form of a crisis.

II.2. The appeal of expansive fiscal policies

In previous sections we saw how the Malaysian government addressed the economic harms produced by stay-at-home orders with different stimulus packages. These stimuli are also not without consequences. Despite the COVID-19 economic crisis being created by government policies (lockdowns), the government did not resist addressing the crisis with the typical tools derived from the analysis conducted in Keynes (1936).

Given:

Y = national product
C = total consumption
G = government spending
I = investments
c = marginal propensity to consume
d = multiplier = 1/(1-c)
Y = C+G+I

in the Keynesian view, if one of the income components (C, G or I) undergoes a variation of *x*, the overall variation in income will be more than proportional and in particular equal to *x*d*. The central idea of the *General Theory* is that «there is a direct and positive relationship between employment and aggregate expenditure» (Sanz Bas, 2011, p. 291). In crisis situations, since increases in C or I cannot be recorded, the only solution – according to Keynes – is to increase G in order to generate growth, or better yet, in order to stimulate employment, the central node of Keynesian policy.

Consequently, according to Keynes, total demand determines the level of employment in the economic system, and the existence of unemployment is none other than the signal that aggregate demand is insufficient for a full utilisation of the production factors. Therefore, full employment is the situation in which the total expenditure level is such as to ensure the employment of all resources. Keynes

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did not believe there was an automatic mechanism in the capitalist economy which would allow aggregate demand to be sufficient. The first reason for this lies in the fact that, according to Keynes, in a growing economy with rising incomes, individuals are induced to save more (in percentage terms). Therefore, in this situation, in order to maintain a constant level of spending it would be necessary for investment to increase in order to make up for this consumption decline in the general populace. But, for Keynes, there is no mechanism in the market capable of connecting savings and investment (Sanz Bas, 2011, p. 291).

In the Keynesian vision, savings are an obstacle to growth because, being a negative counterpart of consumption, it is a negative aspect in determining aggregate demand. And, in addition, the British economist did not acknowledge any link between savings and investment; for Keynes, investments are determined by expectations and liquidity preferences, which in turn determine the interest rate. In our analysis, instead, savings and investments are elements which reflect the time preferences of an economy, and they therefore play a fundamental role in setting the interest rate. In addition, for Keynes expectations are absolutely volatile and unpredictable, making the volume of investments excessively volatile and consequently a cause of crisis; once again, this point of view is radically different with our vision, which instead sees expectations as a "finalistic" (the ultimate purpose of the action) and "causal" (giving rise to action plans and movements of intertemporal coordination) element. It is in this context of volatility that, for Keynes, governments must act in order to stimulate aggregate spending through various measures.

> «First, he proposes the greatest possible reduction of interest rates to encourage private investment as far as possible. As a second measure, since people with a higher income are more likely to save, the government should impose a redistributive tax system to divert income from the wealthy to people with a greater propensity to consume – that is, those with a lower income. This is Keynes's justification of progressive tax systems. As a third measure, the government should make public investments to supplement private investments in case the latter were insufficient» (Sanz Bas, 2011, p. 292).

This is evidently a simplification of a theory that contains considerable elements of complexity. Yet the possibility of obtaining a greater than proportional increase in income as well as an increase in employment simply by increasing G is the element in the theory that became most known in the field of economic policy – and widely used and abused by all world governments, especially after the Second World War, creating the situation of disproportionate public debts seen today. The three manoeuvres described in the previous quote (lowering the interest rate, progressive taxation and public investments) are precisely the tools of fiscal and monetary policy most used by western governments over the last seventy years.

As explained by Landreth and Colander (1994, pp. 819-820),

> «monetary and fiscal policies proved very appealing from a political point of view […]. Markets could be left free to operate as before since the government would not itself have set the level of investments, in being able to influence total income indirectly through surplus or deficit policies in the national budget. For many people, legitimising public deficits as a tool in economic policy had also a second desirable characteristic, since it allowed the government to implement a series of public expenditure programmes without resorting to taxation to finance them».

II.3. The problems with expansive fiscal policies

Hayek (1939, p. 3) demonstrated that consumption does not stimulate but, on the contrary, discourages demand for capital goods. Consequently, stimulating aggregate demand does not have a beneficial effect on income and, as a result, on employment. Following Sanz Bas (2011, pp. 297-299), we can identify three main reasons why such a direct relationship does not exist. The first is that, in modern economies, only a given number of workers is directly employed in production sectors close to consumption, whereby a significant portion of production resources has no direct relationship with end markets. The second reason lies in what Hayek called the "Ricardo effect": for a production structure to remain such, the relative structure of the pricing system must not be changed.

Hayek explains that, after applying Keynesian demand policies, this particular modification takes place in relative prices, and as a result, many entrepreneurs will modify their production strategies and will try new, less capital-intensive production strategies (which are more profitable in relative terms, given the new pricing structure).

This change in production strategies will result in a change in the composition of the demand for capital goods of those entrepreneurs, and will also reduce the aggregate amount of money devoted to buying higher-order capital goods in the market. Therefore, Hayek notes, many entrepreneurs will stop buying capital goods from their usual suppliers. As a result, these suppliers will lose part of their markets and many will be forced to lay off workers or eventually to cease business operations (Sanz Bas, 2011, p. 298).

This means that the change in the structure of relative prices, set in motion by Keynesian policies intended to stimulate demand, triggers a disinvestment process that, by weakening the production goods sector, generates unemployment. Thirdly, Hayek maintains that, even when employment is stimulated with additional spending, it cannot be assumed that increased incomes will be distributed to sectors experiencing a crisis.

In many works published after World War II, Hayek continued to argue that inflationary dynamics is the price to be paid for implementing persistent full employment policies (stimulating aggregate demand) through growing central planning (Hayek, 1950, pp. 174-175); in fact, Hayek precisely disputed that a higher level of employment (full employment) can be achieved and *maintained* by means of monetary pressures (Hayek, 1950, pp. 175-176). The Austrian economist's central thesis is that short term injections of money may well help maintain jobs at a higher level than would be possible otherwise; nonetheless, in the long run, the employment level resulting from these policies is destined to fall. While it is true that an increase in monetary incomes may increase employment, the basic mistake is believing that unemployment is due to insufficient aggregate demand and that pressure on it may therefore automatically generate employment (Hayek, 1950, p. 176). Rather, if spending is spread across the various sectors in a manner other than that in which employment is spread in the same sectors, then it cannot be assumed that an increase in spending will have a positive effect on employment.

Unemployment can be a consequence if the distribution of labour is different from the distribution of demand. In this case the low aggregate money income should be considered as a consequence rather than as a cause of unemployment. Even though enough expenditure may "spill over" into depressed sectors during the process of increasing incomes to temporarily cure unemployment, as soon as the expansion comes to an end, the discrepancy between the distribution of demand and the distribution of supply will appear once again. Where the cause of unemployment *and* of low aggregate incomes is such a discrepancy, only a re-allocation of labour can lastingly solve the problem in a free economy (Hayek, 1950, p. 177).

The main outcome of monetary manipulations, inflationary forces and central planning is to create a distortion in the system of resource allocation. Full employment policies artificially direct demand towards sectors that would not experience such a growth without exogenous stimuli. When the external support comes to an end, probably because inflation has reached an unsustainable level, demand will be forced to return in the direction expressed by the temporal preferences in existence prior to expansive fiscal policies; given this, employment created artificially in all probability will not be permanent. The new unemployment level may even be higher than the pre-stimulus situation, if fiscal injections have not only increased employment in the stimulated sectors but also indirectly in other sectors. This is why the result of inflation is worse than the problem intended to be resolved.

Faced with a disaster caused by inflation, Hayek (1975, p. 4) saw only three possible alternatives:

1. continue with inflation until the total disintegration of the economic system;
2. impose continuous controls, which would bring about centralisation and then totalitarianism;

3. halt monetary expansion and allow the system to attempt to reorganise the distribution of labour and capital through a process of discovery of information and adaptation of preferences, in accordance with the structure of demand and the general structure of intertemporal preferences.

It is clear that solutions 1 and 2 are not desirable; it is equally true that solution 3 cannot avoid a so-called "stabilisation crisis". The end of fiscal expansion may set in motion a readjustment process, a new search for equilibrium, which is called a crisis.

In conclusion, the inflation generated by increased spending, while producing desirable effects in the short term (increase in employment and monetary wages), ends up being harmful. Indeed, distorting the structure of employment in order to maintain an artificially high level of employment requires continual injections of money. Yet this situation is not indefinitely sustainable. When further artificial inflation is no longer possible, the system will begin to move towards realignment, which entails the loss of such artificially created employment, as well as the closure of economic activities launched in sectors where demand has been artificially sustained. The outcome is consequently a situation worse than the initial one, which necessarily requires a readjustment crisis.

II.4. Fiscal policy tools: a critical analysis

Given the analysis conducted so far, which tools are still available to support the economic system without bad unintended consequences amid the current economic crisis? As Hayek (1939, pp. 70-71) put it, if «we have to steer a car along a narrow road between two walls, we can either keep it in the middle of the road by fairly frequent but small movements of the steering wheel; or we can wait longer when the car deviates to one side and then

bring it back by more or less violent jerks, probably overshooting the mark and risking collision with the other wall; or we can try to keep the steering wheel stiff and let the car bang alternately into either wall with a good chance of leading the car and ourselves to ultimate destruction».

Here we are going to analyse the traditional fiscal policy tools to see which ones are less likely to produce undesired negative consequences and instead support the economic system on the way to recovery.

a. Deficit finance

Following Garrison (2001, p. 85), we begin the analysis by wondering whether it makes any difference for the government if expenditures are funded through loans (public debt) rather than taxation. In such a scenario, a portion of the public sector, initially financed through taxation, is now sustained by debt.

In this situation, the government, by issuing additional debt, increases the demand for loanable funds, thereby pushing up the interest rate. This has two consequences: on the one hand, the supply of loanable funds rises (savings are attracted by higher interest rates); on the other hand, because of the increased interest rate, demand for investments in the private sector decreases. Yet lower investments imply an economic structure oriented towards consumption.

Because a high interest rate reduces the profitability of long-term projects, resources are reallocated away from more remote stages of the production process to the benefit of production of consumer goods; this is because of the increased demand for these goods. This reallocation is the result of additional debt. This means that «with a reduced rate of investment, the economy grows at a slower rate, impinging negatively on the consumable output available in the future. To this extent, the debt burden is shifted forward» (Garrison, 2001, p. 87).

The final result of borrowing is a slower growth rate. In general, according to White and Garrison (1999, p. 8), it is vital to emphasise the difference that arises when the government obtains resources through bonds or taxation. This difference is very important for two reasons. Firstly, the level «of spending may in fact rise with the extent of deficit financing»; a greater recourse to debt *may* mean lower taxation on all citizens *today*, but by shifting «some of the burden of current government spending onto future voters who are inadequately represented in today's borrowing decisions». This means that, in this way, a high level of spending implemented by recourse to debt is politically very appealing for governments.

The second reason is that borrowing can be transformed into a vicious cycle, an endless affair, especially if the securities are purchased by the Central Bank, which, by monetising them, creates even more distortion in the monetary supply. In fact, it will create a situation of general uncertainty over the times and ways in which the Government will repay its debt. In this way, government borrowing/indebtedness increases the risk for activities in private sectors.

Similarly, it is wrong to think that the deficit has no role in creating inflation. On the contrary, government debt will materialise in

- higher interest rates (if the government borrows domestically);
- increased inflation (if the central bank monetizes the debt);
- weakened export markets (if the government sells debt abroad);
- tax hikes […]; or
  all the above in some combination (Garrison, 2003, pp. 3-4).

It does not matter where the resources for debt come from: the situation is always negative. In the first instance, the government can resort to domestic borrowing from its own citizens. In this case, if individuals lend money to the State, then their savings will not be available for private sector investments (Garrison, 2001, p. 113). As a result, demand for loanable funds on the part of government overcomes competition with private companies: «High interest

rates attributable to the government's excessive demand for funds "crowd out" private investors as well as consumers» (Garrison, 2001, p. 113)

The second possibility is that the Government receives money from the central bank. This is the classic example of creating money, with the typical outcome that «increased borrowing and spending put upward pressure on prices and wages» thereby creating an inflationary process; subsequent adjustments bring about «inequities, perversities and inefficiencies» (Garrison, 2001, p. 114). While it is true that inflation reduces the real value of debt, this can only occur if two conditions are met: that a large portion of such debt is long-term and that inflation is largely unexpected. Yet this is not the normal situation (Garrison, 2001, p. 114).

The last possibility is that the State turns to the world capital market, obtaining money borrowed from foreign investors and foreign central banks. This has negative consequences on the real economy: a deficit in foreign trade. In fact, countries usually exchange goods for goods. Yet in this case foreign investors deal with goods against State bonds, bringing about serious consequences for the production system of the indebted country, which no longer exports because the Government prefers to pay by becoming indebted (Garrison, 2001, p. 115)..

b. Deficit spending

Here we assume that the level of taxation is held constant and that government borrowing is accompanied by an increase in government spending. There are different options when choosing deficit spending, depending on how the Government decides to use the money obtained through the budget deficit.

Non-economic governmental projects

The first case is that the government uses resources otherwise utilized by the private sector. Yet the State uses these resources

in «a remote and largely isolated military outpost» or to build monuments to political leaders or fallen heroes (Garrison, 2001, p. 92).

In needing money to finance its deficit, the Government increases the demand for loanable funds, thereby driving up the interest rate. As we have already seen, this leads to a decrease in private demand for investments and higher supply of loanable capital (increased savings, given the appeal of a higher interest rate).

Yet higher savings means lower consumption. This case brings about a situation where, since the high interest rate reduces the production period, at the same time there is also less investment and less consumption. It can therefore be concluded that the economy is growing more slowly.

Nationalised industries

In this case, the resources used by the State are not linked with those that remain in the private sector. The situation is rather unusual; in fact, government investments are not always guided by market logic. For example, the government might invest in the steel industry even if the interest rate is not low enough. In any case, state investments bring about an increase in interest rates due to increased demand for loanable funds. As we have seen, this phenomenon in turn generates a reallocation of resources in favour of consumption; yet the situation here is somewhat different, since nationalised industries still leave resources within the remotest stages of production, those involving production goods.

Of course, if investments are made at a high interest rate this could lead to a negative net result; avoiding losses is not the first target of government deficit spending though, which often acts with other objectives, such as "full-employment" (by stimulating employment) or power politics. The final outcome of such action is therefore not easy to foresee.

The general reallocation away from the early stages of production will be partially mitigated by considerations of derived demand and capital complementarity. If, despite cumulative losses, steel is sold at its demand price, the increased supply of publicly produced steel may partially offset the effects of a high interest rate (Garrison, 2001, p. 93).

The discussion about nationalized industries thus shifts the focus away from the macroeconomic relationships that govern a market economy to the economics and politics of resource allocation in a non-market setting. The issues of economic growth, business cycles, and deficit spending give way to the issue of economic calculation in a socialist society (Garrison, 2001, p. 94).

Infrastructure

The last case is that of government investments in infrastructure.

Suppose the government spends its borrowings on infrastructure (highways, waterways, airports, and utilities) or on other programs that may have some public-goods character. It is initially supposed that the government allocates resources for infrastructure in the same way as for a free market regime. Yet this introduces disequilibrium and disproportionalities as regards the remotest stages of the production process. This is because, in their very essence, infrastructure projects are fixed capital investments in remote stages of the production process (time-consuming investments) (Garrison, 2001, p. 94).

In this scenario, the economy moves towards a higher rate of interest, but at the same time the production period becomes longer (because of government investments in long-term production processes – infrastructure). This seems to be not in line with what we have seen so far. In fact, while on the one hand the highest rate of interest (because of higher demand for loanable funds exerted by the government) discourages long term

private investments, thereby reallocating resources towards the production of consumer goods, on the other hand state spending on infrastructure moves resources towards production stages further away from consumption (capital goods). Government action therefore goes against the market: loanable funds are requested, but at a high rate of interest, for spending on long-term projects. It may also happen that someone in the private sector follows the government action «if considerations of capital complementarity are sufficiently favourable» (Garrison, 2001, p. 95).

In this case, the system may record accelerated growth but only if the government is able to override the market process (Garrison, 2001, p. 95). Consequently, «the effects of this fiscal policy cannot be summarily described in terms of the spending alone» (Garrison, 2001, p. 96). In all likelihood, as seen in Ferlito et al. (2021), healthcare infrastructure investments may have been the best way to face the COVID-19 crisis with the tools of public finance.

c. Fiscal reform

The best options for fiscal policies in creating a sustainable growth process come from a tax reform, and in particular replacing an income tax with a consumption tax. A tax on consumption obviously leads to a modification of the structure of intertemporal preferences, thereby facilitating the creation of savings. The structure of preferences becomes more oriented towards the future, thereby generating resources for private investment thanks to increased savings.

So, what may be seen is an increase in both savings (a supply of loanable funds) and investments (demand for loanable funds), without having manipulated the rate of interest in any way whatsoever; in fact, the change of time preference is induced by the new tax system. Furthermore, there is an acceleration of the economic system's growth rate; «the increased growth due to tax reform is sustainable growth» (Garrison, 2001, p. 104).

This is because the interest rate has not been changed by monetary authorities. Tax reform modifies the structure of the intertemporal preferences system. Such an adjustment induced by tax reform does not generate the cycle of expansion and crisis that is the outcome of growth sustained by inflation and monetary distortions.

The key item, therefore, is not tax reform *per se* but the possibility of reducing consumption without changing the interest rate, while allowing a natural change in the structure of time preferences. Garrison (2001, p. 104) emphasises that «it is precisely the reduction of consumption that makes a higher growth rate possible». Following this perspective, it consequently becomes undeniable that the common idea whereby growth is generated by stimulating consumption is completely false, because «stimulating consumption during the transition by means of, say, a transfer expansion may be counter-productive. Again, if the net effect of the transitional dipping down and of the transfer expansion is actually to leave consumption spending unchanged, then the supposed beneficial effects of more rapid growth would be negated» (Garrison, 2001, p. 105).

The positive effects created by a shift toward a consumption tax may be accompanied by an income tax that is – as much as possible – flat and simple; for a tax to be flat and simple, it needs also to be small. In fact, we must refrain from developing a tax state in which the fiscal burden is growing to sustain the very system that supports the tax mechanism. «A bigger and bigger army of bureaucrats is needed to enforce the tax laws, tax inquisition becomes more and more intrusive, tax chicanery more and more unbearable. The absurd waste of energy that this picture entails shows that the meaning of the organization of the tax state lies in the autonomy of the private economy, and that this meaning is lost when the state can no longer respect this autonomy» (Schumpeter, 1918).

For the specific case of Malaysia, this means adjusting the income tax and considering the reintroduction of the Good and Service Tax (GST). We propose here to lower the income tax, both

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on individuals – for whom it should become even flatter – and corporations. The reform should be a combination of modified rates and higher exemption thresholds for lower income groups. We suggest that for the actual details the government should engage with the relevant stakeholders. The aim of the proposal is to help all income earners, in particular those from the lower groups, to cope with the new GST proposed below.

We must avoid developing a large system, because it would be a source of inefficiencies and complexities. A shift toward indirect taxation can help improve collection, but it must be accompanied by higher standards of enforcement – both for direct and indirect taxes – and by the reduction of unnecessary government expenditures.

The reduction of the income tax should be partially replaced by a consumption tax. Against this proposal it may be argued that taxing consumption could have a regressive effect, which means that the relative burden would be higher on the lower income citizens. This would be all the more true with regard to those basic goods which constitute the purchasing basket of the low-income population. Therefore, we suggest a progressive consumption tax; however, such progressivity should not be designed in such a way as to frustrate productive initiatives and luxury consumption, which are key elements for economic growth. The unintended consequence of an overly progressive approach would be to discourage consumption behaviours which benefit the entire economic system; it should not be forgotten that 'punishing' certain types of consumption would affect the production of the goods

involved, bringing harm to the relative value chain and its workers.

Our proposal is as follows:

- exempted goods: items related to the basic consumption habits of the lower-income population, such as rice;
- low-rate GST (3%): key-development items such as culture and education related goods;
- middle-rate GST (6%): all the goods not identifiable with the other three categories;
- high-rate GST (10%): luxury goods.

The rates indicated above should be intended as a suggestion, indicating the direction we believe to be beneficial; such a suggestion remains open for discussion. Reintroducing the GST can become an occasion to test the possibility of a higher degree of tax devolution, with the local states more involved in tax collection so that they may have more direct access to funds that can be used to support the territory. We propose the T-GST to be collected by the state; while 20% of it is retained by the state, 80% is transferred to the federal government.

II.5. Where is the Malaysian economy heading?

The World Bank recently lowered its GDP growth projection for Malaysia for a second time to 4.5% for 2021, from 6% estimated in March and 6.7% in December 2020. Similarly, finance minister Tengku Zafrul Aziz announced that the government is revising its estimate, forecasting expansion around 4%. Let us try to make sense of these figures and understand if they are realistic and how they can eventually be achieved.

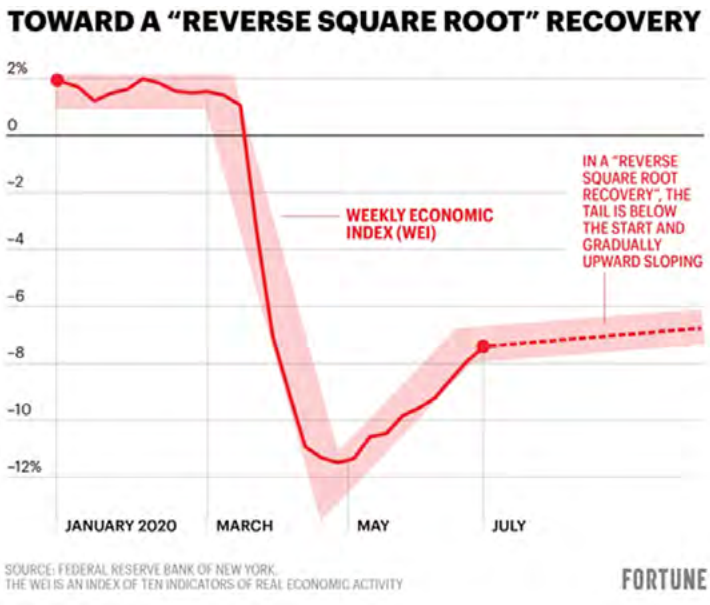
The first important point to be made is that we are talking about annual variations, and the fact that 2020 was an exceptionally bad year needs to be taken into account. The pre-pandemic performances, then, should be our reference point. We know that in 2020 Malaysia's GDP declined 5.6% when compared to 2019. So, if we make 2019 GDP equal 100, the 2020 GDP was 94.4 (100-

5.6). If we assume that in 2021 the Malaysian economy will grow by 4%, we are saying that it will be 4% bigger than the economy in 2020, which means 94.4 + 4%, or 98.176. By assuming a 4% growth in 2021, we are assuming that the 2021 Malaysian economy will be just 1.824% lower than what it was in 2019 (100-98.176).

In a nutshell, finance ministry forecasts (and those by the World Bank as well) are betting on the fact that the economy is getting closer to its pre-Covid-19 size. We believe that this way of putting things is more useful than many sophisticated analyses when we want to answer the question: are these estimates realistic? The question can be made more understandable to lay people if formulated this way: is it realistic to assume that at the end of 2021 our economy will be pretty close to its pre-pandemic level? We believe that a 0% growth, as recently predicted by Fitch (FMT, 2021), with the possibility of an optimistic 2% scenario in case of a radical change in policy as predicted by Casadio and Williams (2021), are more realistic forecasts.

The current scenario, characterized by political instability and severe economic restrictions (not to mention strict control over international travel) may likely drive the country toward a "reverse square root recovery", described in the figure below.

Figure 14: The "reverse square root recovery".



Source: Sraders (2020).

In fact, BNM forecasts would have been realistic only by assuming an immediate end of the pandemic and the reopening of international borders. The main message that the reverse square root shape conveys can be described as it follows:

- A sharp economic decline caused by containment measures;
- A rebound following the reopening of economic activities, or at least part of them;
- A stabilization process around a new structural dimension of the economy, adapted to take into account life with the virus;
- Flat or moderate growth for a certain period of time, equivalent to the time required for the health emergency to be over, confidence to be re-established, and the production structure to re-adapt to a new situation from the demand side.

The last two stages can last years, according to the evolution of the different variables to be taken into account, among which overcoming the virus's power is only one. Ignoring time and its importance for expectation adaptation and production system restructuring is misleading.

Furthermore, however, we need to add to the current analysis the effects created by the expansive fiscal and monetary policies implemented by the Malaysian government and by the Central Bank, policies which also have unintended consequences. Consistently with the analysis in the previous sections, we believe that an economic crisis may hit Malaysia and the world precisely in the moment when we think we will be at the inversion point. Such considerations arise from the uncomfortable news we have about inflation and the emerging stagflation as a mix of rising unemployment and rising prices.

In particular, expansive fiscal and monetary policies created a dichotomy between the real economy and the monetary or financial situation. On one hand we have a real economy in trouble: jobs destroyed, capital investments abandoned, businesses closed for good; these phenomena create deflationary tendencies. On the other hand, instead, fiscal stimuli and low rates created an excess

of financial means available in the market, in contradiction with the situation of the real economy (or, as it is more appropriate, of the production structure); this is creating inflationary pressures.

Such a dichotomy is clearly visible in the basic monetary aggregates, as previously shown. Such an expansionary approach has been made possible by the recent trend considering *discretion* as the main tool of monetary policy, while an alternative view explains that monetary authorities should be limited in their discretionary power and central bankers should be bound by rules, in order for a higher degree of predictability to be available to economic actors (Boettke, Salter and Smith, 2021).

This dichotomy is what is creating the premises for the next economic crisis, which will hit Malaysia and the world *after* the pandemic, when the deflationary tendencies created by lockdowns are over. In fact, the artificial creation of financial means will impede the deflationary process, which we need in this moment. First of all, the availability of financial resources will drive entrepreneurs toward investments that would have not happened otherwise. However, consumers will not necessarily save more to finance the new investment decisions (their purchasing power is still compromised and further weakened by inflation). At the same time, however, entrepreneurs regard the present supply of capital and the present rate of interest as an indication that approximately the same situation will continue to exist for some time.

As we have been observing for a year now, this situation initially brings about an increase in the prices of raw materials and of the capital goods produced with them. At the same time, demand for labour increases, to attract workers towards the new investments, making relative wages increase: this in turn encourages demand for consumer goods, and their prices also increase. The inflation initially seen only for raw materials spreads toward consumer prices.

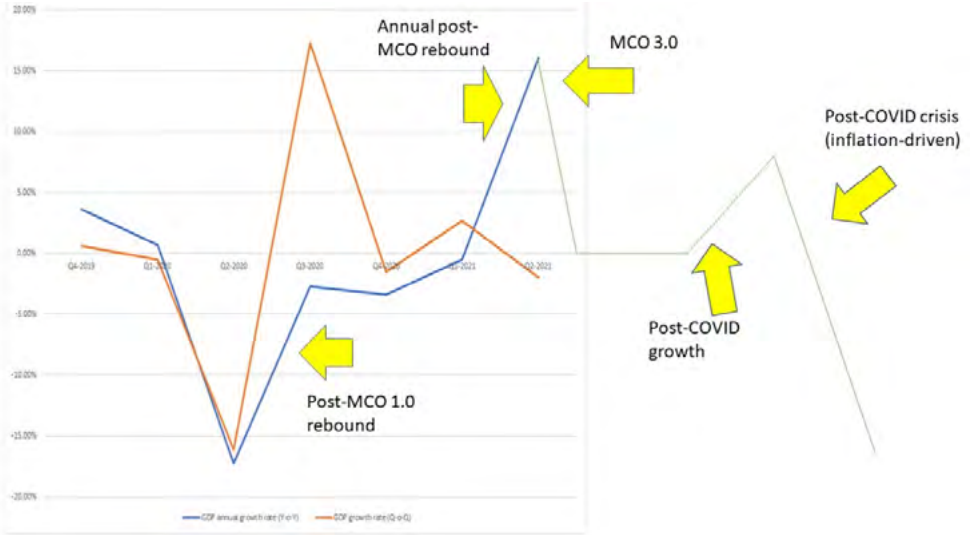
In order to be sustained, this process requires further credit expansion, which would bring about a cumulative increase in prices that sooner or later would exceed every limit. At a certain point,

the interest rate cannot but rise, forcing investment projects to be abandoned (capital destruction). It should not be forgotten that monetary policy discretion played a pivotal role in the emergence of the 2007-2008 crisis, among others.

We may find ourselves in the situation that, at the peak of the recovery, the economy is unable to sustain production oriented beyond its possibilities (because it is on artificial life support). Demand for capital goods runs out. Many economic initiatives set up that rely on excess liquidity cannot be completed, although the debts still must be paid. Many companies must be expelled from the system; capital is scarce and banks raise interest rates. The period of readjustment that follows is called an economic crisis or depression.

The economic trajectory that we can imagine beyond the reverse square-root path is therefore even more unstable. The way in which we see the future economic path of Malaysia is per the following graph. We foresee a flat growth in 2021, following the prolonged MCO 3.0; post-Covid growth will happen only after restrictions are lifted and a post-Covid crisis determined by the inflationary policies implemented so far has run its course.

Figure 15: The post-COVID economic crisis.



Our economy is consequently on the verge of a perilous turn. If inflationary tendencies are not taken seriously, and instead the

dichotomy between the production structure and the financial system is further incentivised, we may experience a severe economic crisis precisely when the post-COVID recovery will seem to be walking on solid ground.

We need to allow deflation to happen in order to restore purchasing power and to rebalance the financial situation with the real economy. This will allow investments to be driven by consistent savings decisions and the recovery to move onto more stable territory.

Such a strategy would need to be combined with a sound economic plan for a true recovery, and not just based on the vicious combinations of lockdowns and subsidies. Such a plan must be built on the necessary restoration of the rule of law, which was suspended with the emergency declaration; in fact, «[c]onstitutional rules and laws which guarantee the ability to communicate allow for better long-term planning and unleash the human creativity necessary to handle unpredictable crises. Recognition of the importance of the rules of reason makes a strong case that rules should be favorable over expediency in times of crisis». Similarly, a true reopening of the economy needs governments to commit to rules which are the preconditions for the market economy to properly work; among them are private property and freedom of contract under the rule of law (Candela and Jacobsen, 2021, p. 52).

A sound economic recovery cannot but be grounded on the importance that private investments have for a country's economy. Investments are mainly driven by profit expectations, rather than by the level of the interest rate, whose role is often overemphasized when thinking about economic growth. It is important for entrepreneurs to expect positive returns within a stable and reasonably predictable price framework in order for them to generate new combinations of capital goods that can drive the economic system on a new development path. Thus, in this regard the role of political stability and the rule of law is much more crucial than any stimulus package or subsidy.

II.6. Conclusions: what to do?

In light of the considerations developed so far, we may conclude that:

- The expansive monetary policy path followed by Bank Negara Malaysia, by creating a dichotomy between the abundant availability of financial means despite the recession, is creating a dichotomy between the financial world and the real economy, planting the seeds for an economic crisis.
- Expansive fiscal policies implemented to address the damages created by stay-at-home orders may result in temporary effects, but will 1) shift the debt burden to future generations and 2) create more unemployment when the stimuli are over.

In a nutshell: the policies implemented so far may become the very root of an economic crisis once the COVID-19 emergency is over and the economy on the path to recovery. Their effects on inflation and unemployment will become more evident when the deflationary pressures currently in play will no be longer in place. Hayek's (1974, p. 25) voice resounds: «the economists are at this moment called upon to say how to extricate the free world from the serious threat of accelerating inflation which, it must be admitted, has been brought about by policies which the majority of economists recommended and even urged government to pursue. We have indeed at the moment little cause for pride: as a profession we have made a mess of things».

What then can we do? Obviously, it is very difficult to suggest solutions to problems that were created by policies (lockdowns) that we were among the few to judge as harmful in light of a sound trade-off analysis. We should not forget that expansive fiscal and monetary policies were implemented to address lockdown harms rather than COVID-19 per se. On several occasions, we recommended a more focused protective approach and targeted investments to strengthen the healthcare system and pharmaceutical research. Unfortunately, some of the negative consequences

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described above are unavoidable: the best scenario for 2021 is a flat growth, while after COVID-19 is over an economic crisis is poised to happen.

We can attempt to moderate those negative consequences now by abandoning lockdowns for good and directing financial resources to the healthcare system. Similarly, monetary policy will need to change in order to allow deflationary tendencies to run their course.

Conversely, a commitment to a no-lockdown policy would help the system naturally free up resources to be invested consistently with the real structure of preferences, while the government should focus on targeted healthcare investments.

Finally, a tax reform, which is based on simplification on one hand and on the reintroduction of the GST (consumption tax) on the other, would favour rebuilding the savings which are necessary not only for the long-term financial stability of households, but also as the sound resources for private investments.

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