ECONOMIC REPORT | Budget 2019 Preview

30 October 2018

Budget 2019: Balancing Reforms, Fiscal & Growth Aspirations

- *Budget 2019: A game-changer to Malaysian economy. As guided by the mid-term review of 11th Malaysian Plan, the fiscal policy approach of the new government will see significant structural changes in term of revenue and expenditure. Heavier weightage will be put on development expenditure particularly on social services or Rakyat-oriented projects. On operating expenditure, we expect increase in subsidies and restructuring in other components of the expenditure.*
- *Clearer policy direction. The upcoming Budget 2019 will set the direction of Malaysian economy in the short term. The budget will unveil areas of priorities for the government which would provide cues and improve confidence particularly for foreign investors. In addition, clearer policy direction will be an impetus and boost for Ringgit in the near term.*
- *Moving towards balanced budget. We forecast budget deficit to hit 2.8% this year and 2019 underpinned by better government revenue, lower DE and moderating economic growth. Malaysia Government is still steadfast with the fiscal consolidation plan and our budget deficit has been in a gradual decline since 2009, from the height of -6.7% to -3.1% in 2017.*

Budget 2019: A game-changer to Malaysian economy. As guided by the mid-term review of 11th Malaysian Plan, the fiscal policy approach of the new government will see significant structural changes in term of revenue and expenditure. Heavier weightage will be put on development expenditure particularly on social services or Rakyat-oriented projects. On operating expenditure, we expect increase in subsidies and restructuring in other components of the expenditure. As for revenue stream, broaden tax base is among key important highlights in order to cover the loss of revenue from GST. Rebound in petroleum tax revenue may not be sustainable particularly in the current challenging environment amid volatility in global energy prices and heighten trade tension. Nevertheless, we expect total government revenue to grow at reasonable pace in the next 3 years between a range of 4%-6% per annum underpinned by steady domestic demand, stable job market and solid economic fundamentals. Challenging external environment however could posed a risk for the estimate.

Clearer policy direction. The upcoming Budget 2019 will set the direction of Malaysian economy in the short term. The budget will unveil areas of priorities for the government which would provide cues and improve confidence particularly for foreign investors. In addition, clearer policy direction will be an impetus and boost for Ringgit in the near term. Nevertheless, strong USD remains a challenge for the Ringgit and other emerging market's currencies due to normalisation in the US monetary policy. Sector-wise, manufacturing and services sectors are expected to experience structural reforms as new policy measures and investment incentives mechanism will be introduced. Construction sector is projected to grow at slower pace due to revision of mega-infrastructure projects.

Malaysia's economy continues to perform. Malaysia's economy is showing resilience and continues to expand at moderate pace. We expect the economy to grow between 4.5%-5% in 2019 due to headwinds from both domestic and external fronts. One of the domestic factors is the ceiling reduction for government development expenditures for RMK11 from RM260 bn to RM220 bn. A reduction in government investment could impact economic growth via direct and indirect channels. Externally, escalating trade war by the US with its global partners, monetary policy normalisation in the US and geopolitical risks are the downside risks in the medium term for the Malaysian economy. As for 2018, we forecast the economy to grow by 5.2%.

Improve revenue as economic growth continues. In line with the expansion in domestic economy, revenue to the government is expected to grow higher this year and stay on upward trajectory until 2020. The increase in revenue is expected to derive from various sources, including corporate and individual income taxes amid improving economic activities. Moving forward, we forecast the government revenue to increase by 6.3% in 2018, in tandem with expectant of GDP growth of 5.2%. However, introduction of new revenue-generating measures to cover the loss of GST and finance the huge government expenditure particularly operating spending is needed. Among the initiatives, broadening tax base such as introducing e-commerce tax, capital gain tax, inheritance tax and other form of taxes will provide additional supports to the revenue.

Table 1: Government Finance (RM Billion)

	2011	2012	2013	2014	2015	2016	2017	2018e
Govt. Revenue	185.4	207.9	213.4	220.6	219.1	212.4	220.4	234.0
Govt. Expenditure	229.0	252.5	253.5	259.1	257.8	252.2	262.6	274.6
Operating Expenditure	182.6	205.5	211.3	219.6	217.0	210.2	217.7	231.6
Development Expenditure	46.4	46.9	42.2	39.5	40.8	42.0	44.9	43.0
Budget Deficits	-43.6	-44.6	-40.1	-38.5	-38.7	-39.7	-42.2	-40.6
Budget Balance to GDP %	-4.8%	-4.6%	-3.9%	-3.5%	-3.3%	-3.2%	-3.1%	-2.8%

Source: CEIC; MIDFR
*1H18 Total Rev.: RM106.8bn
*1H18 Ope. Exp. : RM117.8bn
*1H18 Dev. Exp. : RM20.1bn

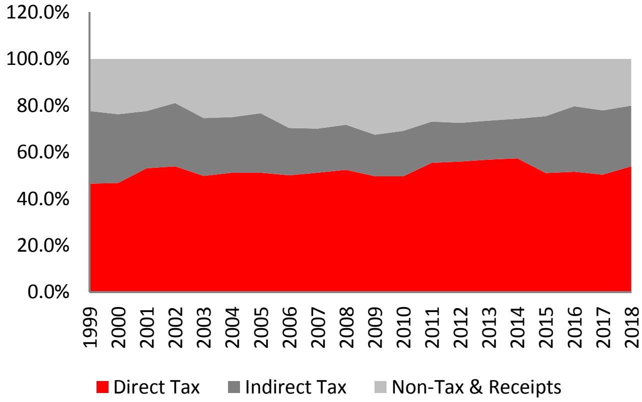
Stabilising oil price a boost for government coffer. For the first nine months of 2018, Brent oil price averaged at $72.8 with average growth of 38.7%yoy. The current price level is way higher than the government's budget assumption of $52 per barrel. According to the Ministry of Finance Malaysia, every $1 increase in average crude oil price will translate into an increase of RM300m to the government's coffer. In simple estimates, the increase in average oil price at the current level will give additional RM6.2bn to the government's revenue. Petroleum tax, royalties and dividend from oil & gas activities are expected to increase in tandem with the upward price trends. Since 4Q17, petroleum tax revenue increases by average of 196.5%yoy for 3-consecutiive quarters. Hence, improvement in the oil prices will give significant booster towards overall Malaysia's economic activity via output, employment and income given that the oil & gas industry has strong value-added multiplier effects and efficient economic linkages. As for 2019, we estimate crude oil prices to average at $75 per barrel. With expected improvement in petroleum related revenues, move toward implementation of targeted fuel-subsidy will also help lessen the financial burden of the government.

Table 2: Government Revenue (RM Billion)

	2011	2012	2013	2014	2015	2016	2017	2018e
Revenue	185.4	207.9	213.4	220.6	219.1	212.4	220.4	234.0
Tax Revenue	134.9	151.6	156.0	164.2	165.4	169.3	177.7	180.7
Direct Tax	102.2	116.9	120.5	126.7	111.8	109.6	116.0	137.4
Corporate	46.9	51.3	58.2	65.2	63.7	63.6	64.5	75.0
Petroleum	27.7	33.9	29.8	27.0	11.6	8.4	11.8	18.0
Personnel	20.2	23.0	23.1	24.4	26.3	27.6	28.9	33.3
Others	7.4	8.7	9.5	10.1	10.2	10.0	10.9	11.1
Indirect Tax	32.6	34.7	35.4	37.5	53.7	59.7	61.6	43.3
Non-Tax	50.5	56.3	57.4	56.4	53.6	43.1	42.7	53.3

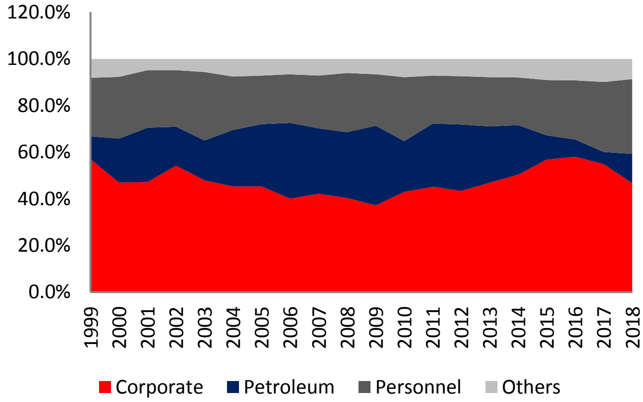
Source: CEIC; MIDFR

Chart 1: Govt. Revenue Share by Source (%)



Source: CEIC, MIDFR

Chart 2: Direct Tax Revenue Share by Source (%)

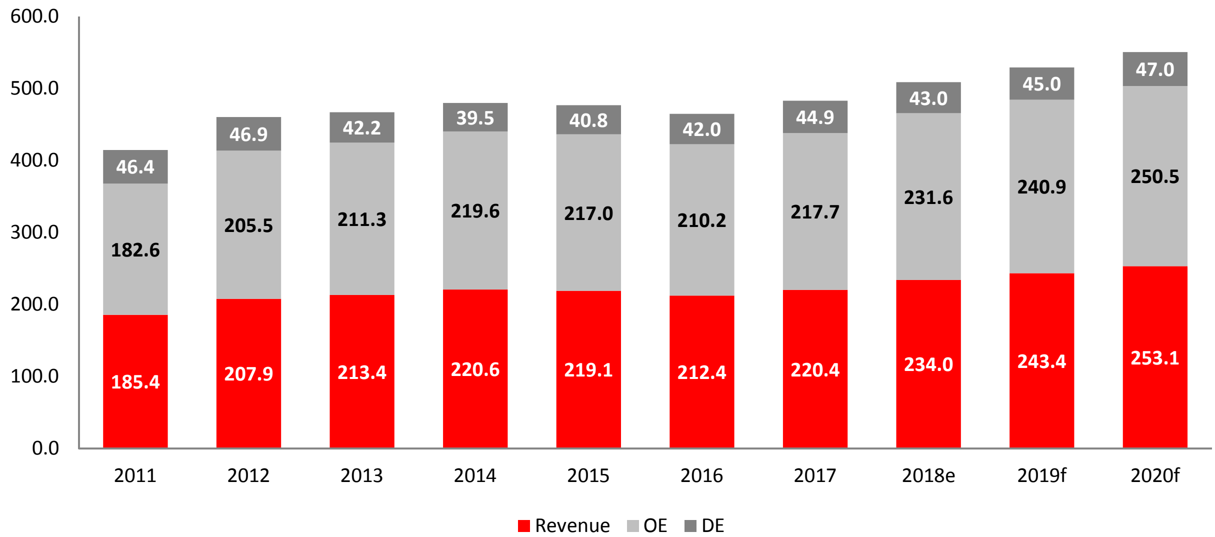


Source: CEIC, MIDFR

Expecting changes in government's operating expenditure. In the next 2 years, we expect share of development expenditure to increase hovering between 20%-22% while operating expenditure to experience adjustments especially on debt service charges, supplies & services and subsidies. Trimming down current government debt level is among major priorities under the PH government. Debt services charges to total expenditure ratio returned to above 10% after 10 years, 10.2% in 2006 and 10.6% in 2016. On a flip side, subsidy rationalisation plan which started in 2010 resulting drop from peak RM44.1bn in 2012 to RM22.4bn in 2017. Henceforth, we opine the expenditure of federal government is expected to face structural changes over 2-year period. The changes will be on gradual pace as the return of targeted petrol-subsidy mechanism, debt restructuring and greater government finance transparency via open tender and full implementation of accrual accounting method.

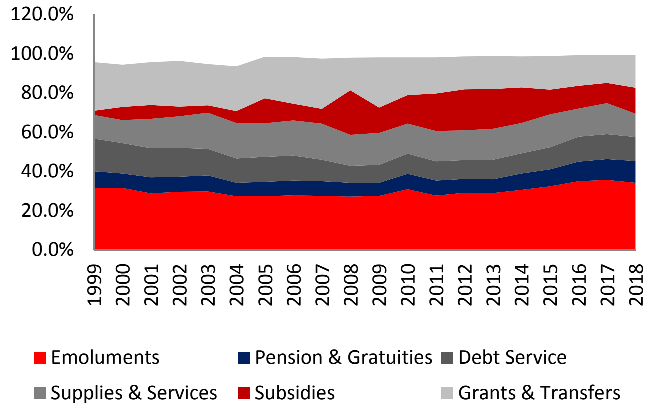
Higher development expenditure, extra focuses on social services expenditure. In 1999, 70.2% of total expenditure is operating expenses while 29.8% for development spending. After 2003, the share of DE declines to 17% whereas OP surges to 83% in 2017. By component, DE consists of defence & security, economic services and social services. Economic services which constitutes about 54.3% of the expenditure focuses on development projects including transport, industry and agriculture & rural developments. On the other hand, social services cover 27.3% focuses on education, health and housing. Moving forward, we foresee greater expenditure allocation on social services-related projects in order to improve socio-economic development in Malaysia. Even though the government slash down budget allocation from RM260bn to RM220bn, we opine DE to rise in 2019 and 2020 due to under-utilization of DE in the previous years. Supposedly with RM260bn, yearly average of DE in 2016-2020 should be RM52bn whereas total DE for 2016 & 2017 were only RM86.9bn. Referring to the midterm blueprint, over 4,000 ongoing projects will be continued specifically related to affordable houses, schools, hospitals and roads. Various programs specifically designed for rural areas such as entrepreneurship, technical training, and tourism are also expected to be unveil in the upcoming budget. These measures are to improve the wellbeing of the rakyat and bridging the gap between rural and urban area.

Chart 3: Government Revenue, Operating & Development Expenditures (RMbn)



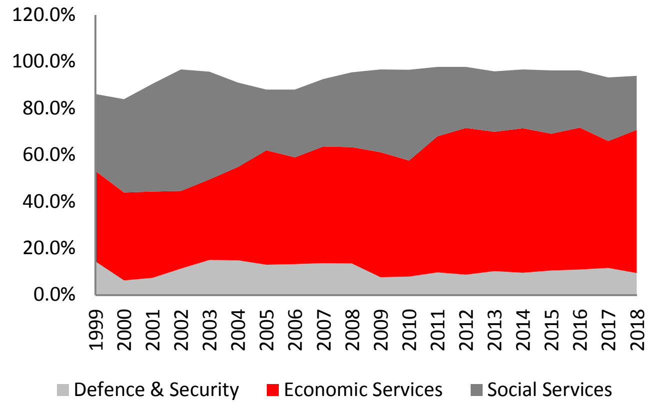
Source: CEIC, MIDFR

Chart 4: Operating Expenditure Share by Type (%)



Source: CEIC, MIDFR

Chart 5: Development Expenditure Share by Type (%)

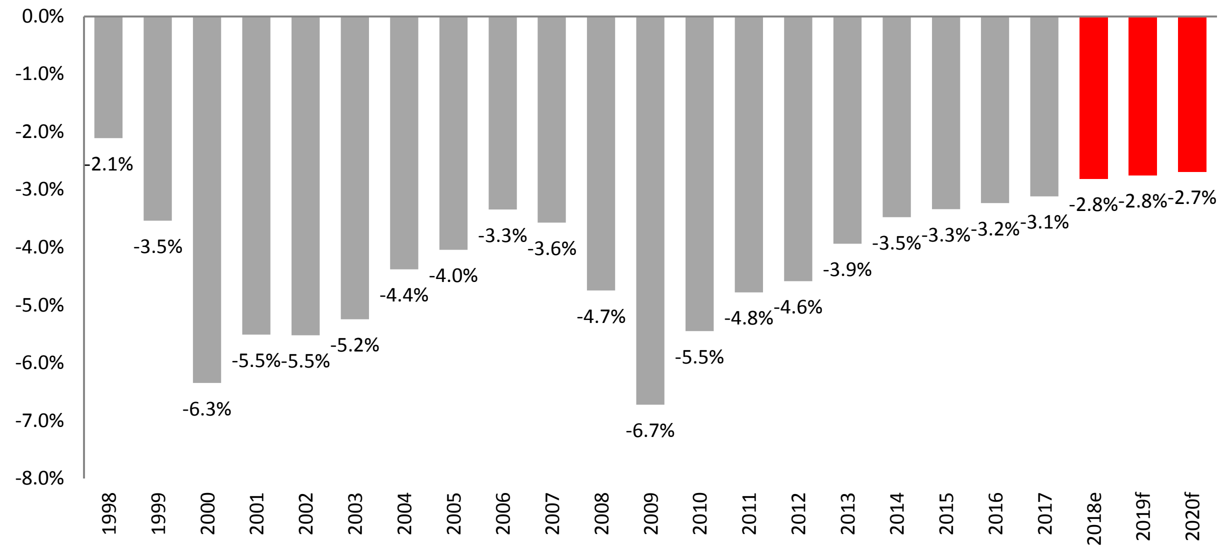


Source: CEIC, MIDFR

Moving towards balanced budget. We forecast budget deficit to hit 2.8% this year and 2019 underpinned by better government revenue, lower DE and moderating economic growth. Malaysia Government is still steadfast with the fiscal consolidation plan and our budget deficit has been in a gradual decline since 2009, from the height of -6.7% to -3.1% in 2017. The government revises down initial target of budget deficit 0.6% to 3.0% by 2020. Based on our estimates, the budget deficit is predicted to improve at gradual pace reaching 2.7% by 2020. The prospect of achieving a balanced budget is indeed tough to achieve in the next 2 years particularly with the environment of energy & commodity prices volatility and market uncertainties in global economy.

Strong personnel income tax reduce fiscal gap. In line with the macroeconomic pattern, Malaysia's structure has shifted from export-reliance to private consumption-driven. In 2017, personnel income tax share of total government revenue is 17.3%, higher ever recorded. The share has been on uptrend since the GF'09, together with corporate tax while share of petroleum tax decreases. The improvement of Malaysia's budget deficit ratio is mainly due to robust growth in personnel income tax. GST introduction in 2015 did provide additional support but not significant as the direct tax component. For instance, post-GFC average growth for personnel income tax is 116.3%yoy, higher than its long-term average of 18.7%yoy. Comparatively, corporate tax's 5.7%yoy vs 16.3%yoy and petroleum tax increases by 16.2%yoy against 29.3%yoy. Thanks to GST, indirect tax grows on average of 11.4%yoy during post-GFC beating long-term average of 9.3%yoy. Moving forward, stable job market will provide additional support to domestic demand as well as enlarging personnel income tax receipts.

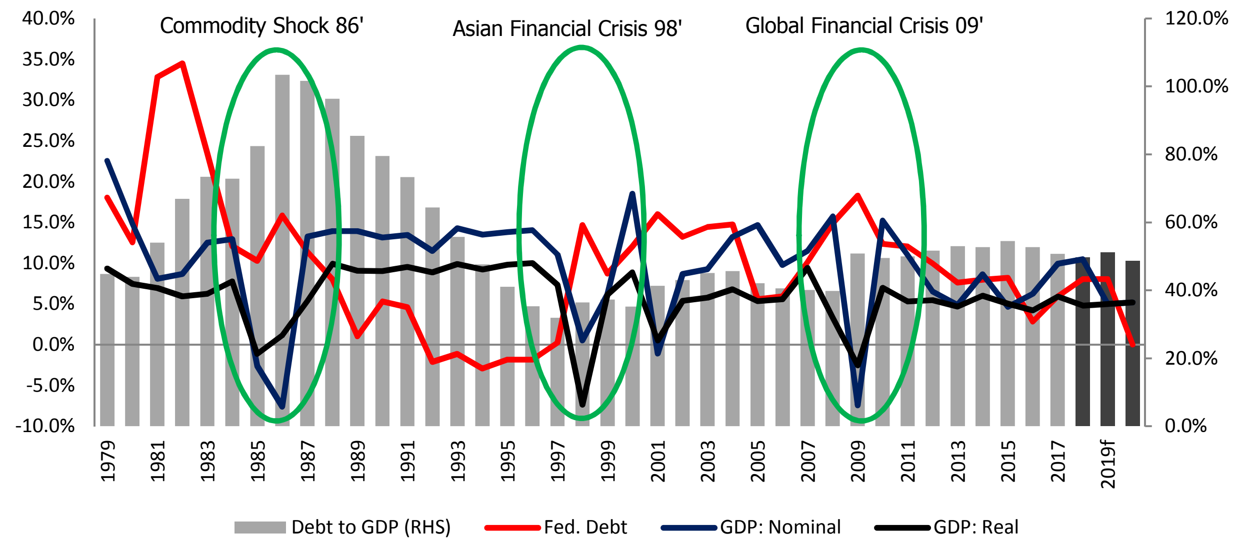
Chart 6: Budget Deficit to GDP Ratio (%)



Source: CEIC, MIDFR

Debt to GDP ratio is influenced by growth and inflation. The ratio is a relationship between nominator and denominator. Stagnant debt with solid economic expansion will lower down the ratio level and vice versa. For instance, the ratio hits record high in 1986 at 103.4% amid of huge contraction in Malaysia's nominal GDP by -7.6% while government debt was expanding at 15.9% during the year. Since the Commodity Shock 1986, Malaysia's government debt has been growing at moderating pace and in fact experiencing contractions during 1992-1996 as Malaysia had budget surplus during those years. At the moment, the debt-to-GDP ratio is at stable condition, below 55% ceiling level and reflecting resilient macroeconomic foundation for the country. Moving forward, we foresee the ratio will decline further underpinned by tightening fiscal management and steady GDP growth.

Chart 7: Govt. Debt & GDP Performances (YoY%)

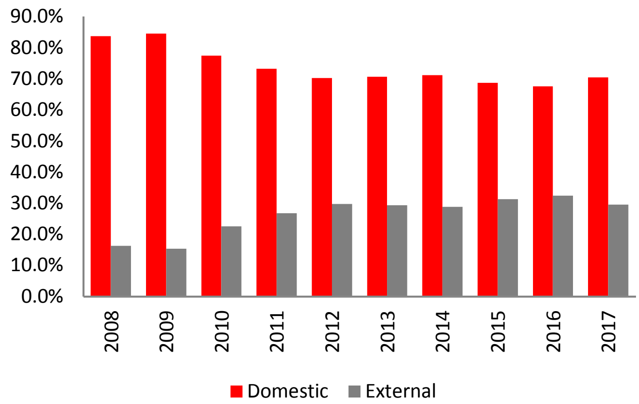


Source: CEIC, MIDFR

Government debt holding composition. For every RM1 debt owned by the Malaysian government, 71 cents belongs to domestic while 29 cents to foreign in 2017. Even though the share of foreign debt is increasing, the debt growth has been moderating since 2010. In line with the trend, overall government debt is growing at similar pace. In fact, foreign debt shrank by 3.6% last year while domestic debt surged by 10.5%. With the current structure of government debt, risk of contagion effects is minimal due to trifling exposure to foreign debt.

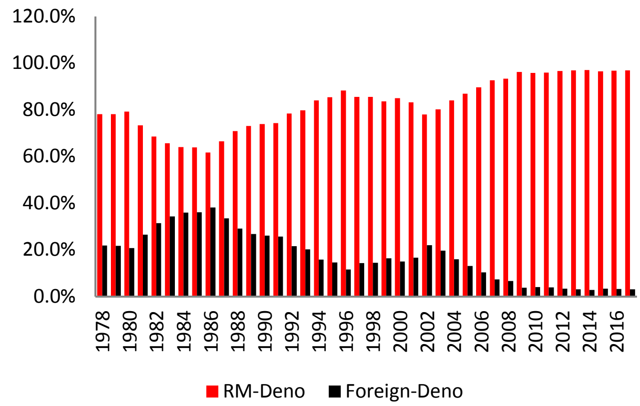
Foreign-denominated currency debt declines to insignificant level. As of 2017, most of government debt is RM-denominated close to 97%. Oppositely, only 3.1% of the debt is foreign-denominated. The foreign-denominated debt has been below 10% since 2006. Therefore, the government debt position is relatively safe and resilient even in the event of massive devaluation of RM. By type, government securities and investment issues are two main components under the RM-denominated debt. Government securities and investment issues constitute about 54.8% and 40.3% respectively last year while treasury bills and other loans hold another 4.9%.

Chart 8: Govt. Debt Share by Source (%)



Source: CEIC, MIDFR

Chart 9: Govt. Debt Share by Currency (%)



Source: CEIC, MIDFR

11th Malaysia Plan Midterm reviews a new impetus. Under the mid-term review of 11th Malaysia Plan, the government emphasizes on six policy pillars. The theme is ensuring more meaningful economic growth. Among the six, reforming governance towards greater transparency & efficiency of public service, enhancing inclusive development & wellbeing, pursuing balanced regional development, empowering human capital, enhancing green growth and strengthening economic growth. In general, the mid-term review aims at improving the Rakyat's purchasing power as well as providing sufficient economic development and equitable distribution of national wealth and income. In addition, the blueprint highlights on uplifting human capital and productivity level in the country. Via the mid-term review, Malaysia is set to become a developed economy and inclusive nation.

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