21 January 2015

MALAYSIA

Revised Budget 2015: Positive on growth, negative on sovereign outlook.

- **The new oil price assumption for the revised budget at US$55p.b. (US$100p.b. previously) would see a revenue shortfall of RM8.3bn.**
- **As a result, spending plans for 2015 needs to be cut, however, the government can only cut back RM5.5 billion from Operating Expenditure whilst leaving Development Expenditure plans unchanged to support economic growth, now forecast to come off slightly to 4.5 - 5.5% (earlier forecast: 5-6%).**
- **The net effect would see the budget deficit to be higher by RM2.8bn. The government estimated that this would amount to 3.2% of GDP against 3% estimated previously.**
- **The higher than expected deficits now may put the sovereign rating under downward pressure as deficits management is seen to continue to face challenge with oil prices likely to be structurally lower in the next few years, unless the budgeting structure changes.**

Budget 2015 has been revised down to reflect the declining oil prices and the weakening Ringgit. The revised 2015 Budget was announced by the PM yesterday on the back of the rapid decline in oil prices which rendered the assumption of oil price at US$100p.b. likely to no longer hold. In view of this, the government had revealed that the revised Budget would be based on the assumption of Brent crude price at US$55p.b. That would lead to a shortfall in expected revenue by RM8.3b to RM226.9bn from the earlier budgeted at RM235.2b.

The variation in revenue was smaller than our own estimation. Our internal estimation showed that oil-related revenue to come in at RM46.0b with the significant reduction to come from petroleum tax revenue by RM10.6b with relatively small reduction in non-tax revenue i.e. Petronas dividends, export duties and royalty. We had estimated that the shortfall in revenue to be offset by savings in fuel subsidies as much as RM10b, leading to overall variance in the Budget by RM4.7b. That is considering all other revenue components remained unchanged. However, the government expects to be able to offset some of the revenue shortfall with increase in dividends payments by the GLCS and GLICs (RM400 million) and bigger collection of GST (RM1bn) by means of greater compliance among businesses.

The revenue shortfall to be offset by cutting OpEx, instead of DevEx to ensure economic growth to only come off slightly to 4.5 - 5.5% against earlier projection of 5 -6%. This should be seen as a positive move for growth as the risks of a sharper slowdown is mitigated although at the expense of higher budget deficit. Cutting back expenditure from OpEx is not easy, hence resulting in a cutback of only RM5.5b and budget deficits still higher than budgeted earlier by RM2.8bn. That would put the deficit at 3.2% of GDP, assuming that nominal GDP stays unchanged from the earlier forecast.

Table 1: Variances from the earlier 2015 Budget

RM'b (unless otherwise stated)	Revised Budget (US$55p.b.)	Old Budget (US$100p.b.)	Variance
Revenue	235,219	226,919	-8.3
Operating Expenditure	223,448	217,948	-5.5
Net Development Expenditure	47,467	47,467	0
Deficits	35,668	38,496	-2.8
Real GDP growth (YoY%)	4.5 – 5.5%	5.0 -6.0%	-0.5
Deficit (% of GDP)	3.2	3.0	-0.2

Source: MoF, MIFDR estimates

Table 2: MIDFR Estimation on Oil-related revenue

All in RMb	2014e	2015f (Based on crude oil price at USD105/barrel)	2015 – Revision (MIDFR estimation based on crude oil price at USD55/barrel
Petroleum Income Tax	28.3	25.6	16.0
Petroleum Royalty	5.7	5.5	3.3
Petroleum export duties	1.9	2.1	1.2
PETRONAS dividends	29.0	27.0	25.5
Total	**64.9**	**60.2**	**46.0**

Source: MoF, MIDFR

Real GDP growth now expected to be marginally lower at 4.5 - 5.5% (MIDFR estimate: 4.5 – 5.0%) Historically, the Federal government would most of the time cut back Development Expenditure whenever thre was a shortfall in Revenue or bigger Operating Expenditure from the levels budgeted. This time around, the government had surprised the market with its move to keep the Development Exoenditure unchanged. We believe that is because this year is the closing year of the 10th Malaysia Plan and even at the much higher level budgeted for 2015, the total Development Expenditure since 2011 already falling short of the plan projection. The government expects with this move will ensure that real GDP growth would not slip off significantly from the earlier target of 5.0 – 6.0%, We expect that the negative wealth effect coming from the lower oil prices and pullback in asset prices could still be significant despite the offset from the lower fuel prices and the floods crisis could prove to need more funds than expected given the extent of damage.

The higher than expected deficits now may put the sovereign rating under downward pressure. While growth now facing lower risk of a sharper slowdown, the higher deficits now put higher risk on budget deficit overshooting again given the limited room to manoeuvre further cutback in spending should oil prices averaging lower than expected. That implies the deficit management would continue to face challenge with oil prices likely to be structurally lower in the next few years, unless the budgeting structure changes. That has led Fitch Rating, to announce that it would review Malaysia's rating in the first half of 2015 and that it may downgrade the sovereign, stating that "further measures might be required" for the country to meet its target of a balanced budget by 2020. Fitch Rating has recently reaffirmed its "negative" outlook on Malaysia since its assessment last July, having lowered it from "stable" in 2013, with long-term local and foreign currency debt rating of "A" and "A-" respectively.

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