Economic Research

KDN No.: PP14787/11/2010(026023)

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Vol.: ER/017/2010

SPECIAL COMMENTARY: Pre-Budget 2011

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Our Viewpoints

MARC is of the view that Budget 2011 will serve as a blueprint to put Malaysia on a sustainable growth trajectory in line with the visions and aspirations set forth in the Economic Transformation Programme (ETP) and the New Economic Model (NEM) outlined by the government in the earlier part of the year. The ultimate goal is to get Malaysia out of the so-called “middle-income trap” and move the country into a high-income status to enable it to realise the objectives of Vision 2020 within the next 10 years.

Assurance to investors and the business community at large will be needed at this juncture, as the government continues its relentless efforts to re-invigorate private investments which will catalyse long-term organic growth in the economy. As such, we expect the government to reaffirm its stance on liberalisation policies and emphasise transparency in doing business. We foresee possible announcements of liberalisation of other services subsectors to improve competition and create a level playing field. In addition, the government may propose some fiscal and non-fiscal incentives to promote private investments in the country.

Following the government’s commitment to addressing the persistent budget deficit, we anticipate more measures to be unveiled to help deal with the government’s shrinking coffers. This may include selling government equity stakes in selected companies, which would also boost liquidity in the equity market and can act as a means to re-allocate government resources to more productive areas and to yield higher multiplier effects. Also, a small increase in excise duties for the brewery sector may be proposed as this has not been imposed in the past four years. As a part of the gradual fuel subsidy removal, the government may fine-tune the mechanism that ensures proper market pricing of RON97.

The government’s concern over depleting oil revenue may lead to further clarification on the details about the impending implementation of the goods and services tax (GST). However, as GST is normally associated with rising general prices, we are of the opinion that the implementation will be slightly delayed following unfavourable economic conditions and at the same time, Malaysia’s tax band may be restructured as it is currently too narrow and often causes disincentives for workers, especially foreign experts.

As efforts to remove subsidies will likely entail rising prices of goods and services, some measures to lighten the burden on the *rakyat* may be proposed, including higher tax relief for taxpayers with children pursuing higher education, and separate tax reliefs for Employees Provident Fund (EPF) contributions and insurance premiums. These moves would at the same time help to boost the insurance industry through higher penetration rates. The government may also propose a private pension fund to provide a safety net for employees in the private sector. A proposal to implement a minimum-wage policy may also be mooted to ease the burden on the country’s lowest-paid workers.

We believe that measures will be proposed to prevent macro imbalances that can emerge from a build-up in property prices and an overstretched household balance sheet. These measures could take the form of a maximum allowable level of loan-to-value ratio (LVR) for a selective segment of the market, or a slight increase in the real property gains tax (RPGT). For consumers, the rise in credit-card debt will be managed through higher income requirements, maximum number of credit cards or credit limits.

Although Malaysia has achieved commendable stature as the leading global *sukuk* issuer with its bond market being the third-largest in Asia ex-Japan, the government will need to institutionalise measures to boost the sophistication of the domestic capital market to avoid having this prestigious position wrested away by regional competitors. In the same manner, initiatives should be taken to boost liquidity in the corporate bond market’s secondary market and expand the investor base to include retail investors whose participation is currently hindered by the substantial initial outlay that bond investments typically entail.

Critical issues to consider in Budget 2011

Despite the excitement stirred by the details revealed of the ETP by the Performance Management and Delivery Unit (PEMANDU) and the general guidelines provided by the NEM, Malaysia will face challenges in achieving Vision 2020 goals. Expected continuous volatility in the global economy, coupled with domestic issues, will likely lead to a bumpy road for the country in realising its ultimate goals. Nevertheless, aggressive efforts undertaken by the Malaysian government in recent years provide a clear message that it is firmly committed to bringing about real change in the direction of the overall economy.

The following critical economic issues will, in our view, have important bearings on the consideration of measures to be proposed in the upcoming Budget 2011:

Nascent global economic recovery that may prevent smooth expansion in global trade in the near term. With the G3 economies (the US, Europe and Japan) still struggling to find firm footing, export-oriented countries in Asia – Malaysia included – will find themselves at the mercy of global trade performance. Signs of rising protectionist policies among countries are a real cause for concern. This is evidenced by incidents between Japan, China and the US that later translated into strong rhetoric on putting up trade walls. We are of the view that trade frictions may deepen if the US labels China as a currency manipulator, causing more protectionist walls to be erected between the countries that will eventually shrink trade volume in the medium term.

The need for sufficient fiscal and non-fiscal incentives to realise the goals set by the ETP to promote critical National Key Economic Areas (NKEAs). The key objective of the ETP is to ensure an existence of a conducive environment and resources to re-energise private investments in Malaysia. This is critical, as the target of moving the country into the high-income category will not likely be achieved unless the private sector takes the lead in investing in the economy. As there is an urgent need to ensure the smooth implementation of the ETP, the government will likely reaffirm its stance on liberalisation policies and emphasise transparency in doing business. We opine that substantial fiscal and non-fiscal measures will be introduced to spur the private sector to increase its investments in the country.

A relatively huge budget deficit that needs to be gradually reduced over the years. Malaysia is firmly committed to continuously addressing the budget deficit problem that has plagued the country since the 1997/98 Asian Financial Crisis. While the country successfully slashed the deficit to 3.2% of gross domestic product (GDP) in 2007, the most-recent global crisis resulted in fiscal expansionary policies to be implemented in 2009, causing the budget gap to widen to 7% of GDP. Therefore, Budget 2011 will likely reiterate the government's stance on lowering the deficit to an acceptable level in the next year through divestment of selected government stakes in some companies and further reductions in subsidies. We also think that a clearer timeframe on the introduction of the GST will be announced, although there could be a slight delay in implementation, given the prevailing unfavourable economic climate. Indeed, we are of the view that the government is on track to trimming the deficit further in 2011. In fact, with higher-than-expected revenue, the ratio of the deficit to GDP may fall to below 5% in 2011.

Rising cost of living further burdening some segments of the population. With prices of essential goods continuing to climb following the government's gradual removal of subsidies, the low-income group's welfare is increasingly eroded. The severity of the problem is discernable when one considers that 88.7% of Malaysian workers earn less than RM3,000 per month, according to the Ministry of Human Resource (MoHR). Being sensitive to the *rakyat*, the government may introduce measures to provide some relief by increasing taxpayers' disposable incomes through higher tax relief for those with children pursuing higher education, and separate reliefs for taxpayers' contributions to the EPF and insurance premiums. These will ensure that the *rakyat* can cope with the rising cost of living, especially a worrisome development in big cities.

High dependency on foreign workforce that needs to be holistically addressed. The issue of foreign labour has been constantly debated, as policymakers strive to achieve the delicate balance between discouraging the displacement of local workers in favour of foreign labourers and the need for uninterrupted business operations in industries that utilise predominantly foreign workers. The long-term goal is to open more doors to local talents to make Malaysia less dependent on foreign workers. One of the ways to do this, according to some industry groups, is by ensuring a decent minimum pay to attract local workers. Therefore, the government may emphasise the need for or even introduce minimum wages in selected industries.

A high level of household debt, partly caused by rising mortgage loans. Malaysia's household debt rose above 70% of GDP in 2009, and has remained above 60% of GDP since the early part of this millennium. Rising household debt was partly attributed to a sharp increase in mortgage loans, due to the booming property sector and easy credit extended by the banking sector. A rapid increase in property prices has raised some concerns among policymakers, as a sudden about-turn in prices will wreak havoc on the real economy just as it did in countries like the US and the Emirate of Dubai. Hence we expect some measures will be introduced to ensure that a property bubble does not develop.

A relatively high level of borrowing through credit cards. Despite accounting for a relatively small portion of total household debt, credit cards and their popularity among consumers have grown in prominence in recent years, which may result in a consumer crisis if the economy experiences a sudden downturn. The number of principal cardholders has jumped sharply to more than nine million at end-2009, compared with a mere 2.3 million at the beginning of the new millennium. Learning from Korea's experience in 2003, the government may well consider measures to alleviate the problem of overstretched borrowing through credit cards.

Rising competition in capital market development that may affect the attractiveness of Malaysia's Islamic market. Being the third-largest bond market in Asia ex-Japan (trailing behind South Korea and China) and the largest global *sukuk* issuer, Malaysia's capital market is held in high regard in Asia. Malaysia's aspiration to be the Islamic hub of the region has of late been met with stiff competition, especially from the neighbouring countries of Singapore and Indonesia. Taking full cognisance of this, the Malaysian government will likely institutionalise more measures to boost the sophistication of the capital market under the advice of Bank Negara Malaysia (BNM).

Broadening investor base in the fixed income market. This market is currently dominated by institutional investors. To solidify the domestic bond market's status as one of the most developed in the region, we are of the view that the government would move to expand the investor base, particularly in the corporate bond market. Most of the foreign fund flows into the domestic debt market hitherto have been channelled to the government bond market, which in our opinion is due to the illiquid nature of the corporate bond market's secondary activity. Policies could also be introduced to encourage the establishment of dedicated bond funds for retail investors whose participation is currently hindered by the substantial initial outlay that bond investments typically entail.

What are the measures that would likely be proposed in Budget 2011?

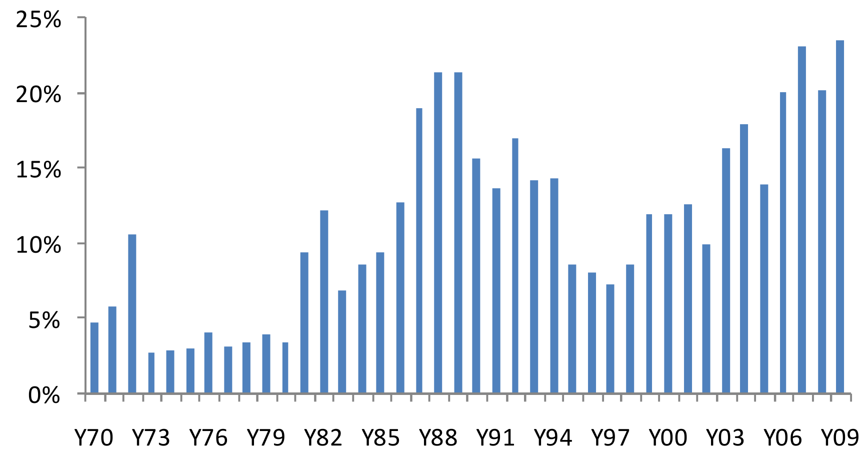
✓ **Incentives to smoothen the implementation of the ETP**

On September 21, 2010, the ETP Open Day was organised by PEMANDU, and 12 NKEAs were announced, which included the oil & gas, palm oil, electrical & electronics and tourism sectors. The NKEAs are supposed to drive the Malaysian economy from middle-income to high-income status by the year 2020. As most of these industries are highly capital–intensive, there exists a dire need for incentives to stimulate private-sector participation, and these incentives could take the form of fiscal and non-fiscal measures, where fiscal measures would be, amongst others, capital investment and reinvestment tax allowances which would attract and eventually promote investment activities among businesses, while non-fiscal measures could include creating more efficient and less-bureaucratic processes to speed up project implementation. In addition, we expect the government to reaffirm its stance on liberalisation policies and continue emphasising transparency in doing business. We foresee possible announcements of liberalisation of other services subsectors to improve competition and create a level playing field.

✓ **Selling of government equity stakes**

We believe that this could be one of the best ways to raise government revenue and at the same time create more liquidity in the equity market, especially for foreign investors. To a significant extent, this can also be a means to reallocate government resources into more productive use and yield more substantial multiplier effects. However, the one-off revenue generation from such an exercise will result in the higher opportunity cost of a stable stream of income. Indeed, the share of investment interest and returns, forming part of the indirect taxes collected by the government, has been steadily rising from 4.8% in 1970 to 23.6% in 2009. Therefore, the government would be selective in divesting its shareholdings, and those in non-core companies should preferably be the first to go.

Chart 1: Share of investment interest and returns of total government revenue



Sources: CEIC & MARC Economic Research

✓ **Further reduction in fuel subsidy and higher duties in the brewery sector**

To boost the government's coffers, a small increase in excise duties in the brewery sector may be proposed as this has not been imposed in the past four years. In addition, as part of the gradual fuel-subsidy removal process, the government may fine-tune the mechanism to ensure proper market pricing of RON97. This is critical, as crude oil prices may resume their uptrend if global economic recovery firms up going forward. Thus far, the price of RON97, which was supposed to reflect market forces, has not been changed since the last hike in July 2010.

✓ **GST timeline**

The government will likely use this avenue to present the timeline for GST implementation. This is important to guide the *rakyat's* expectations, especially when such a measure can be potentially inflationary. If possible, the measures should not be introduced in the immediate term to avoid piling unnecessary burden on households, as Malaysians are still adjusting to the new price structures resulting from the successful implementation of the abovementioned fuel-subsidy reform in July.

✓ **Personal tax relief for children pursuing higher education**

In light of higher living costs, additional relief may be proposed for families whose children are pursuing higher education. Currently, the personal relief for this category is RM4,000, which was last raised in 2006. Such an upward adjustment would indubitably reflect the government's stepped-up promotion of human capital development in its quest to stem the worrisome brain drain that has exacted a toll on the nation's development in past years.

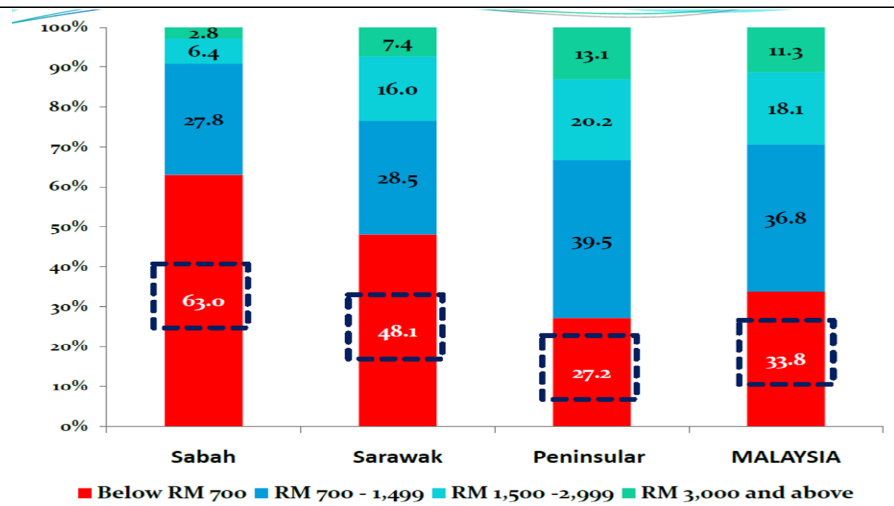
✓ **Separate tax reliefs for EPF contributions and insurance premiums; establishment of a private pension fund**

Under the current ruling, a combined relief of RM6,000 is given for EPF contributions and life insurance premiums. Separate reliefs of, say, RM6,000 for EPF contributions and another RM6,000 for insurance premiums (life, medical and education) may be considered by the government. This move will help to increase the insurance penetration rate in Malaysia and raise taxpayers' disposable income. In addition, a private pension fund may be proposed to provide a safety net for workers in the private sector.

✓ **Articulation of a minimum-wage policy**

In the interest of achieving a high-income economy, the government may consider the formalisation of a minimum-wage policy for selected industries. According to a 2009 Ministry of Human Resource survey, approximately 33.8% of workers in Malaysia earn salaries below RM700 a month, while another 36.8% receive between RM700 and RM1,499 per month. In essence, more than half of all Malaysians earned less than RM1,500 per month! Therefore, a mechanism establishing a credible minimum-wage policy should be in place to ensure that every Malaysian can savour the fruits of economic development.

Chart 2: Present wage structure (National Employment Return 2009)

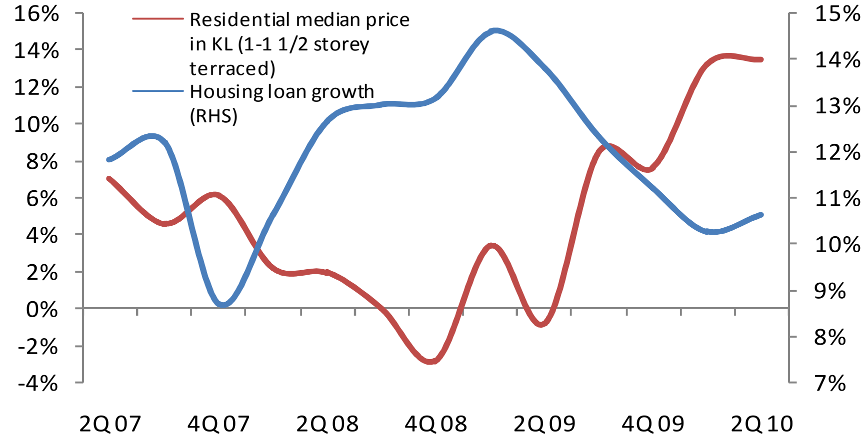


Source: Ministry of Human Resource (MoHR)

✓ **Lending restrictions to the property sector**

There have recently been suggestions to reduce the loan-to-value ratio (LVR) for lending to properties to deter speculative activities in the property market. The current LVR is at 90%, and the news flow seems to suggest that it may be reduced to 80%. We believe that such a measure, if implemented, will be a sensible one as there are reasons to expect more upward pressure on asset prices. Failure to address this may lead to a massive correction in property prices. These measures should also be selective in nature, as the new ruling will obviously be detrimental to first-time buyers if implemented across the board. Ideally, the middle to high-end segment should be targeted for lower the LVR. Alternatively, the current level of RPGT at 5% could be raised slightly to clamp down on speculative activities in the property market.

Chart 3: Residential median price for 1-1 ½-storey properties in KL (y-o-y%) vs. housing loan growth

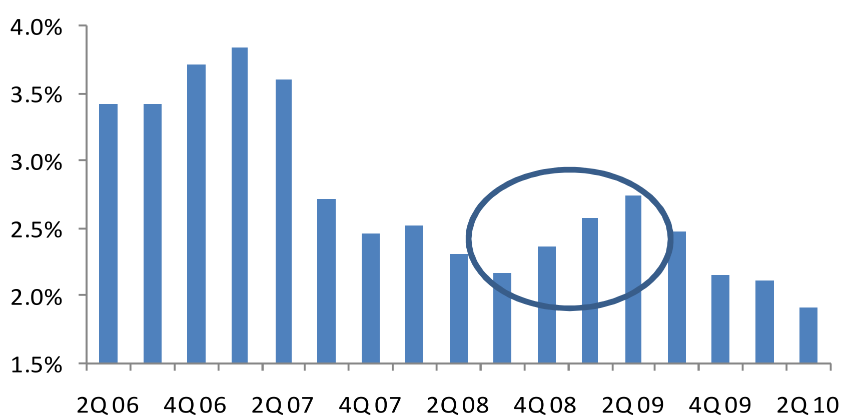


Sources: CEIC & MARC Economic Research

✓ **Regulation on credit cards**

As part of the initiatives to control household debt, we anticipate measures that will limit household exposure to credit-card facilities, including an introduction of a single credit limit for borrowers, which will ultimately have a direct impact on the pervasive reliance on credit cards as a means for day-to-day spending. Credit limits are at present left to market forces, which has resulted in a spike in the amount of credit granted. Although the non-performing loan (NPL) ratio for credit cards appears to be manageable at this juncture, it would be wise to take pre-emptive measures against the worst-case scenario, especially in light of the increase in the said ratio from 2.2% in 3Q2008 to 2.7% in 2Q2009 at the height of last year's recession.

Chart 4: Credit card NPL ratio



Sources: CEIC & MARC Economic Research

✓ **Boosting liquidity in the secondary market through a bond investment vehicle**

Some funds might be allocated to set up a fund management unit that will invest in investment-grade bonds (rated A+/A1 and below) to expand the secondary market for such bonds. We think that the fund management unit would be appropriately housed in, or monitored by, government institutions with proven track records in the financial markets, such as Khazanah Nasional, or the EPF. Alternatively, the allocation could also be channeled to existing asset management companies with specified investment objectives to encourage more active trading in higher-yielding papers (which are typically offered by lower-rated bonds) to derive the following benefits of a liquid secondary market:

- The mark-to-market values of portfolios will more accurately reflect real and current valuations, as benchmark prices used are based on the actual transacted price/yield, rather than mathematically derived fair valuations.

- The availability of a credible benchmark bond index arising from improved secondary-market liquidity conditions could encourage foreign investors to take on greater exposure in the ringgit corporate bond market as an alternative to their existing exposures in the ringgit sovereign bond market.

- A liquid market aids the price-discovery process for both issuers and investors, which should support active trading in the bond market.

- The availability of an active secondary market, especially for lower-rated bonds, would encourage investors to purchase such bonds from the primary market, thereby improving market demand for A-rated bonds.

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Published and Printed by:

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