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MALAYSIAN RATING CORPORATION BERHAD
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SPECIAL COMMENTARY: Pre-Budget 2012

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In a nutshell

- Budget 2012 will come into play when the global and domestic economies are embroiled in multiple challenges arising from the unstable macro conditions in the major developed nations as the debt crisis continues to unfold in Europe and the fragile growth in the United States (US) comes under threat as consumer and business confidence remain precarious. The Malaysian economy, in particular, is currently facing external challenges following the weakening of industrial production and exports, while domestically, government finances are constrained by the relatively high budget deficit (despite the recent improvement during 1H2011) and government debt being above its long-term average.

- Measures in Budget 2012 will likely be focused on supporting domestic economic activity to counter the anticipated decline in the external sector and its attendant effects on the country's export sector. Notwithstanding this, we do not anticipate a broad-based cut in taxes for individuals and corporations as the government is committed to bringing down the overall fiscal deficit. Instead, we expect that Budget 2012 will focus on alleviating the impact of rising living costs and addressing imbalances in the economy. Indeed, the government would likely attend to the high level of household indebtedness, the continuous rise in prices of high-end properties, as well as the government's relatively overstretched financial position.

- We also opine that addressing the worrisome lack of affordable homes will be another of Budget 2012's key foci. As part of the measures to address this issue, we feel that a formal, contractual arrangement standardised across states, whereby cess-fund contributions from developers can be used for building low-cost houses, is not a bad idea, as this money can then be utilised by Syarikat Perumahan Negara Berhad (SPNB) to build low-cost houses in suitable areas. As for the problem of rising household debt, the government can grant the Credit Counseling and Debt Management Agency (AKPK) more authority to be more active in the agency's debt management program (DMP). Promoting the DMP can lead to better cash flows for highly indebted households who still have net positive monthly incomes.

- To alleviate the people's financial burdens from the higher cost of living, an increase in the housing allowance for civil servants who work in high-cost areas could be a sensible measure since the last revision was done six years ago in Budget 2005. We believe that this can help increase the disposable incomes of government employees in urban areas, which will then be positive for private consumption and the economy as a whole.

- Similarly, to relieve the burden on the middle-income group (which has not benefited considerably from existing government measures that focus on the low-income segment), we feel that a reduction in the personal income tax rates for those with chargeable incomes of RM50,001 – RM70,000 and RM70,001 – RM100,000 is justified to help offset the rising cost of living. In the previous Budget, the focus was on reducing income tax rates for the high- and low-income groups.

- A separation in the reliefs accorded to Employees Provident Fund (EPF) contributions and insurance premium payments as well as an increase in the relief amount are favourable measures that could serve two major objectives: (1) to reduce the amount of taxable incomes for individuals, which would then increase their disposable incomes, and (2) to encourage the purchase of medical insurance which would help to increase the insurance penetration rate in this country. By allowing EPF withdrawals for the purchase of medical insurance, the burden on the *rakyat* and the government can be reduced. This is a significant positive outcome – should it be realised – as healthcare costs have been and will invariably continue to rise.

- The government will also be addressing the conundrum of rising food prices in the upcoming Budget. Efforts will likely be made to ensure a long-term solution for the problem is instituted. We opine that increasing domestic food production would be the way to go, as the country still possesses abundant resources such as land and capital that are necessary preconditions for such an initiative. Additional allocations will probably be made to improve agriculture infrastructure (such as drainage and irrigation) to promote greater productivity in the sector.

- In addressing the relatively frothy high-end segment of the property market, measures to complement the reduction in the loans-to-value ratio (LTV) may be instituted. In this regard, we would not be surprised if the Pigouvian tax were to be introduced as part of the government's arsenal in tamping speculative activities in the property market. This tax can reduce negative externalities in the property market associated with asset price inflation and ensure the affordability for genuine homebuyers. A reversion to the old real property gains tax (RPGT) regime on a sliding scale could perhaps be considered to address the froth in the high-end segment of the real estate sector.

- The secondary market for bonds could do with a boost from a fund management unit that invests in investment-grade bonds (especially A-rated bonds), with this unit ideally placed under the purview of government bodies with illustrious performance in the financial markets, or even asset management corporations that aim to encourage more active trading in higher-yielding papers.

Budget 2012: a sneak preview

Overview

Budget 2012, to be tabled on October 7, is prepared against a backdrop of high uncertainty, especially in the external sector. Hence, the government will have to walk the tightrope between promoting domestic demand and keeping its financial resources strictly in check, with any spending programmes to be based on the twin factors of affordability and economic importance. Indeed, statistical releases on the external front have not been encouraging, particularly when growth in the Industrial Production Index (IPI) turned negative in July while export growth moderated in the same month. Despite that, domestic demand remained relatively resilient although signs of a slowdown have emerged, especially in private consumption, as evidenced by the decline in motor vehicle sales. Still, spending patterns as well as consumer sentiment indicators continue to suggest that consumer spending will prevail in the near future.

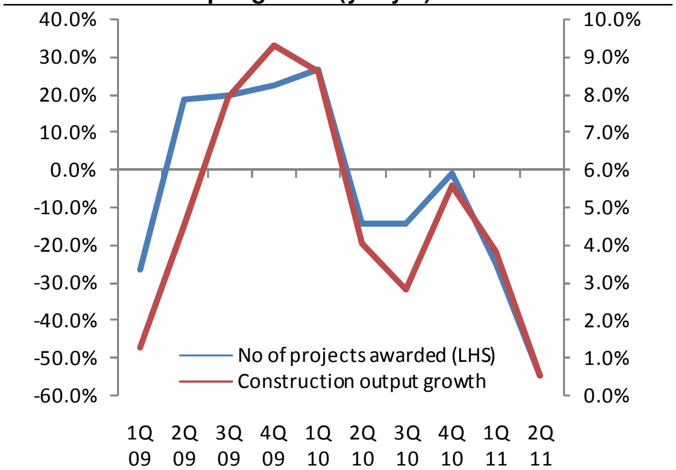
Government finances are in stable condition, having registered an overall surplus in 2Q2011 largely on account of higher revenue collection and lower expenditure. In 1H2011, the fiscal deficit stood at RM4.4 billion or 1.1% of gross domestic product (GDP), far lower than the expected shortfall of RM45.5 billion or 5.4% of GDP for the whole of 2011. The government thus has considerable room to ramp up spending in 2H2011, especially in light of the heightened external risks.

In the past, operating and development expenditure tended to increase at an average of 45% and 112% respectively between 2H and 1H of the year. We can expect a similar trend this year. Thus far, the pace of projects awarded and development expenditure have been uninspiring, with these measures recording a decline of 54.7% year-on-year (y-o-y) (1Q2011: -24.8%) and 31.4% (1Q2011: -9.9%) in 2Q2011. The ramifications have understandably been rather devastating, with construction output growth decelerating sharply to 0.6% (1Q2011: 3.8%) during the same period. It is hoped that the government will address procedural inefficiencies to enable speedier project implementation and benefit from the consequent multiplier effects.

Nonetheless, we also believe that fiscal flexibility is curtailed with the government debt-to-GDP ratio standing at 53.0% in 2Q2011. According to the Ministry of Finance's *Economic Report 2010/2011,* government borrowings are guided by several rules and guidelines, amongst them are the Loan (Local) Act 1959 and Government Funding Act 1983 which stipulate that the combined outstanding domestic borrowing for development expenditure cannot exceed 55% of GDP. If these requirements were to be strictly adhered to, then there is clearly not much fiscal space left for the federal government to borrow.

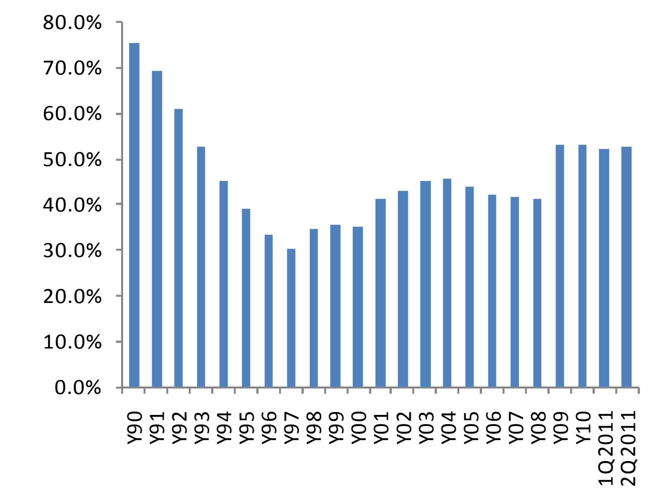
Against this backdrop, we do not expect broad-based tax cuts for individuals or corporates although tax reductions may be given to the middle-income group which has not benefited considerably from existing government measures that focus on the low-income segment. Instead, the government would likely lay out a definitive timeframe for the implementation of the Goods and Services Tax (GST) to ensure that businesses are sufficiently prepped up for the tax. Indeed, clearer guidance on this would earn the government confidence from investors and, to some extent, international rating agencies as it would demonstrate the government's unwavering commitment to more disciplined financial management. In the same manner, we think the government will not be in a rush to slash its subsidy bills, but will instead continue to ensure financial assistance will be more targeted towards the lower-income segments of society.

Chart 1: Number of projects awarded (y-o-y%) vs. construction output growth (y-o-y%)



Sources: CEIC & Construction Industry Development Board

Chart 2: Government debt as % of GDP



Source: CEIC

Issues and proposed measures

- **Affordable homes**

Issues

It has been the government's intention to ensure that every citizen has the opportunity to own a roof over his or her head. This was reflected in the National Housing Policy (NHP) which was launched on February 10 this year with the objective to provide adequate, comfortable, quality, and affordable houses to improve the well-being of the people. However, examination of the profile of sales of residential properties in the past 21 years reveals that houses priced at RM100,000 and below have been losing market share, while houses costing RM500,000 and above continue to be in strong demand (see Charts 1 and 2).

These results connote a drastic reduction in affordability for low- to medium-cost houses as households have to contend with the rising cost of living. As a result, renting a house has become a viable solution, especially for the lower-income segments of the population. However, rentals have been on an upward trajectory, detracting from tenants' incomes and their resultant spending on other goods and services. Typically, expenditure for housing rentals account for about 17.2% of total household expenditure, based on the consumer price index (CPI) weight at year 2010 prices. This has been on the rise from 15.6% (the previous CPI weight based on year 2005 prices).

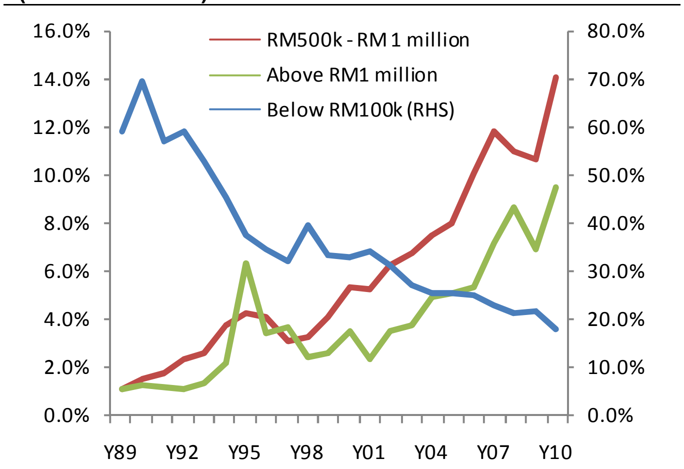
To put things into perspective: consider a monthly income level of the bottom 40% of the population, which stood at RM1,440 as of 2009, according to the *Household Income Survey* by the Department of Statistics, Malaysia (DOS). Using the 2010 CPI weight, rental expenses should be in the region of RM248 a month. In 2004, the monthly income for this segment of society is about RM1,101, whilst subsequent rental expenses are RM172 per month (using 2005 CPI weight). A rough estimation would hence yield a 44.2% increase in housing rental between 2004 and 2009, compared with a 31% increase in monthly income during the period.

Proposed measures

The government is thus presented with a clear-cut case to intervene in the property market to improve the opportunities available to lower-income individuals to own a house. In the past, property developers were required to set aside a certain percentage of their development land for the building of low-cost houses. This has, however, discouraged some developers from fulfilling their obligations as land costs can be prohibitive in some areas, particularly in or near city centres. Although there is an informal arrangement where developers contribute to a fund, terms and conditions of such transactions vary from state to state.

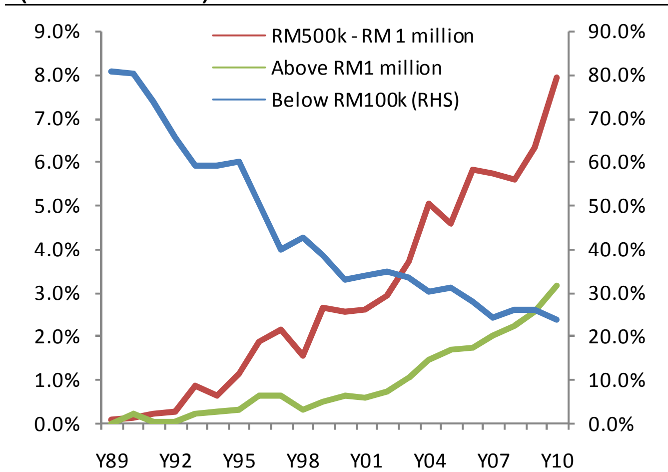
To address this conundrum and improve the effectiveness of the allocation of capital, this requirement could be replaced with a formal, contractual arrangement standardised across states, whereby cess-fund contributions from developers can be used for building low-cost houses. The government, through SPNB, can then utilise the funds to develop low-cost housing in areas identified as appropriate.

Chart 3: Residential property sales in Kuala Lumpur (KL) (% of total sales)



Source: CEIC

Chart 4: Residential property sales in Selangor (% of total sales)



Source: CEIC

- **Household debt**

Issues

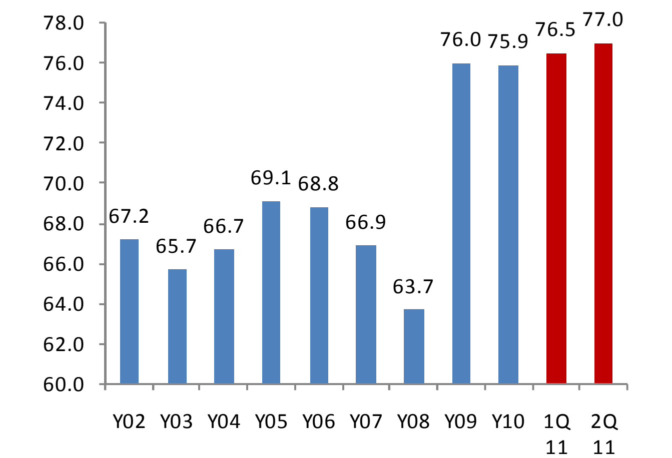
The issue of rising household indebtedness has taken centre stage in recent years, but the government has hitherto been proactive in averting the potential negative consequences of this phenomenon. Indeed, the establishment of AKPK in April 2006 was an important initiative in avoiding systemic risks in the financial sector, especially in times of economic downturns. As a result, non-performing loans (NPL) in the household-loans category continued to fall to 2.0% in 2Q2011 from 7.4% in 2Q2006 despite the recession and global volatility in 2009. However, recent reports about Bank Negara Malaysia being concerned over credit card debts have raised some anxiety about the sustainability and strength of household balance sheets.

Proposed measures

Despite the lower NPLs, there is no reason to be complacent in addressing the untenable household indebtedness level, particularly when external risks loom menacingly over the horizon which can potentially undermine households' debt-servicing ability. To this end, we believe that promoting the use of debit cards (as opposed to credit cards) could be a step in the right direction. In 2010, cashless payments via credit cards amounted to RM79.8 billion, while debit cards recorded RM4.7 billion. Perhaps, the government could grant tax benefits to debit-card users whenever they make purchases.

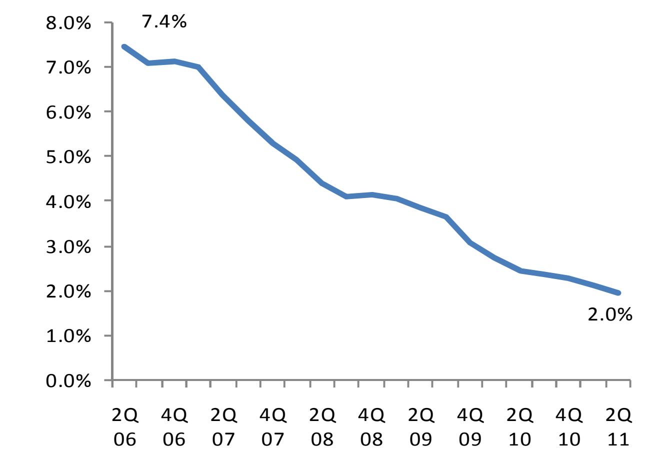
Apart from that, the AKPK should be granted more authority in exercising its responsibilities so that the agency can play a more active role, particularly in the execution of the DMP. Promoting the DMP can lead to better cash flow for highly indebted households who still manage to have positive net monthly income after deducting all necessary expenses. This would help sustain the strength of private consumption as households would enjoy higher disposable incomes and maintain high discipline in their household budgeting.

Chart 5: Household loans as % of nominal GDP



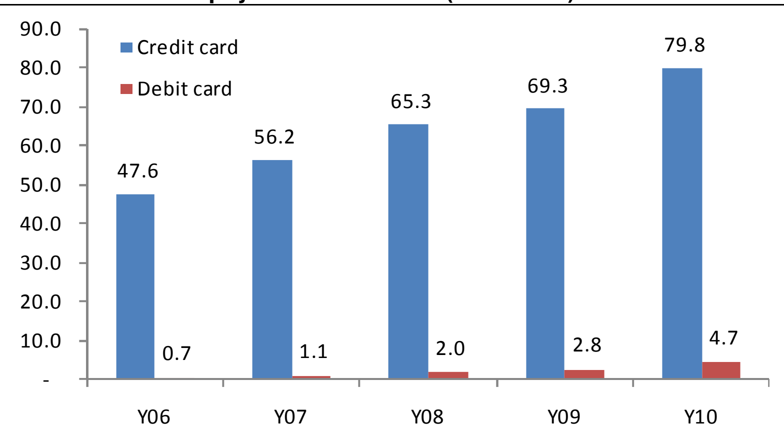
Source: CEIC

Chart 6: Gross NPL ratio for household loans (%)



Source: CEIC

Chart 7: Cashless payment instrument (RM billion)



Source: BNM

➢ **Urban poverty**

Issues

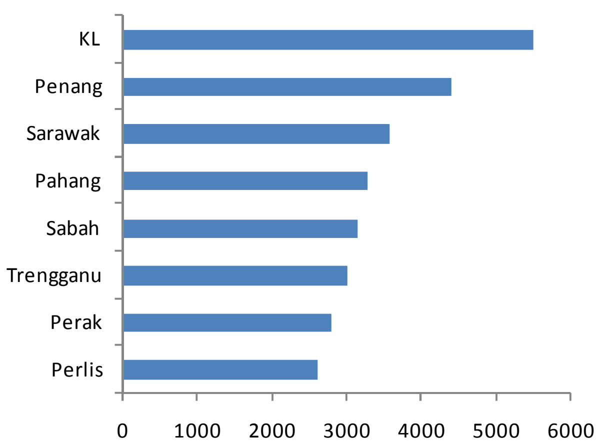
It is a known fact that price levels are not geographically uniform, and generally speaking, urbanites pay more for the same product compared with their rural counterparts. Examples of this phenomenon range from food and beverages to property and house rentals. This price inequality has detracted from the urban population's welfare, despite them earning more than the rural settlers. For instance, the *Household Income Survey* (HIS) in 2009 showed that the average monthly salary for households in Kuala Lumpur stood at RM5,488, while those living in Pahang, Terengganu and Kelantan earned a monthly income of RM3,279, RM3,017 and RM2,536 respectively. However, a stark difference in residential property prices (RM355,242 in KL; RM155,603, RM134,624 and RM113,182 for Pahang, Terengganu and Kelantan respectively) existed. This should also translate into different housing rentals amongst these states.

The government has demonstrated commendable resolve in addressing such imbalances. The impending implementation of the minimum wage policy (scheduled to be effected by the end of this year) is decidedly a step in the right direction. However, labour unions have expressed discontentment with some of the proposed measures. Thus, a certain degree of fine-tuning is expected before the policy's full implementation.

Proposed measures

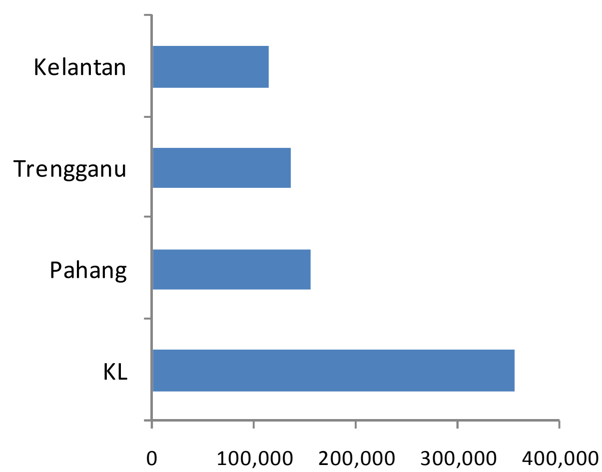
Increasing the housing allowance for government servants who work in areas with high cost of living could be sensible as the last revision took place in Budget 2005. The measures should improve the disposable incomes of those who live in urban areas. Presently, those in job grades 41 – 44 are entitled to a housing allowance of RM210 per month, while those in job grades 1 – 40 receive RM180 a month.

Chart 8: Average 2009 household monthly incomes (RM)



Source: DOS

Chart 9: Average prices for 1 – 1 ½ storey terraced homes as of 2Q2011



Source: CEIC

➢ **Rising food prices**

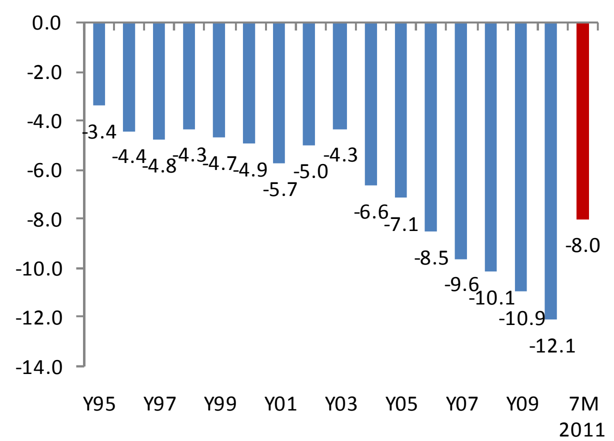
Issues

Malaysians are grappling with high prices, but particularly for food items. The food and non-alcoholic beverages component, accounting for the largest share of CPI weights, is presently close to 5.0%. Compounding the issue is the fact that the country is rather vulnerable to gyrations in international food prices as its trade balance in foodstuff remains in deficit. In the first seven months of this year alone, the trade deficit in foodstuff stood at RM8 billion, compared with RM12 billion for the whole of 2010. Lower self-sufficiency in some food categories could possibly explain the yawning deficit (assuming consistent demand for such products as meat, milk, wheat and rice) as the country is forced to import to satisfy local demand.

Proposed measures

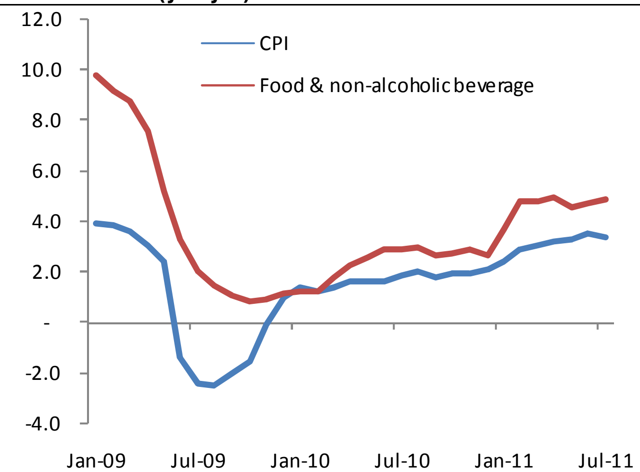
Increasing food production looks to be the best way to address such deficiencies as the country has abundant resources such as land and capital. To this end, allocations to improve agriculture infrastructure (such as drainage and irrigation) are needed to promote productivity in the sector. Also, fully harnessing the latest technologies is critical to yielding high value-added activities by commercialising research findings from various institutions of higher learning and government bodies such as the Malaysian Agricultural Research and Development Institute (MARDI).

Chart 10: Trade balance in foodstuff (RM billion)



Source: CEIC

Chart 11: CPI (y-o-y%)



Source: CEIC

➢ **Other possible measures**

Personal income tax cut for middle-income earners

To promote and sustain private consumption, middle-income earners should be compensated the same way as low-income earners. As such, it is proposed that personal income tax rates for those with chargeable incomes of RM50,001 – RM70,000 and RM70,001 – RM100,000 be reduced slightly to compensate for the rising cost of living (currently, these chargeable incomes are taxed at 19% and 24% respectively). In the previous Budget, focus was on the reduction in taxes for the high- and low-income groups.

Separate tax reliefs for EPF contributions and insurance premium payments

A separation of the reliefs accorded to EPF contributions and insurance premium payments as well as an increase in the amount of relief provided would serve two major objectives: (1) to reduce the amount of taxable incomes for individuals and consequently increase their disposable incomes, and (2) to encourage purchases of medical insurance and help increase insurance penetration rates among Malaysians (currently, a combined relief of RM6,000 is given for insurance premium payments and EPF contributions).

At the same time, withdrawals of EPF contributions are only allowed for contributors to cover medical expenses associated with critical illness. By allowing withdrawals for the purchase of medical insurance, the burden on the citizenry and the government can be reduced substantially.

Tax relief for personal computer purchases

In light of speedy technological advancements, it would be sensible for the government to provide a tax relief for personal computer purchases on a more frequent basis. This is to ensure that Malaysians are well equipped with the latest state-of-the-art technology which can also serve as a key catalyst for the creation of high-quality human capital (currently, the tax relief granted is RM3,000, applicable only once every three years). This relief could be granted every two years instead to promote the adoption of new technology amongst the citizenry.

Introduction of the Pigouvian tax to tamp speculation in property markets

The government may opt to introduce the Pigouvian tax to tamp speculative activities in the property market. The Pigou tax is commonly associated with environment economics, where the imposition of such tax would help establish equilibrium in circumstances where pollution results in negative externalities to society. In the context of the property market, negative externalities come in the form of asset price inflation, which considerably reduces home affordability, especially for genuine homebuyers.

As such, a reversion to the old RPGT regime on a sliding scale (see Table 1) could be considered in addressing the prevailing froth in the high-end segment of the market.

Table 1: Historical RPGT

Category of disposal	Prior to 1 Apr 2007	From 1 Apr 2007 - 31 Dec 2009	Effective 1 Jan 2010
Within 2 years	30%	0%	5%
Within 3rd year	20%	0%	5%
Within 4th year	15%	0%	5%
Within 5th year	5%	0%	5%
Within 6th and subsequent years	0%	0%	0%

Source: Inland Revenue Board

Improve secondary-market liquidity via a bond investment vehicle

The secondary market for bonds could do with a boost from a fund management unit that invests in investment-grade bonds (especially A-rated bonds), as the country seeks to boost the sophistication of the domestic capital market and maintain its stature as the world's leading *sukuk* issuer. This unit should ideally be placed under the purview of government bodies with illustrious performance in the financial markets, or even asset management corporations that aim to encourage more active trading in higher-yielding papers (higher yields are a feature of lower-rated bonds). Indeed, the benefits of a liquid secondary market are many, including:

- Mark-to-market portfolio values will better reflect real and current valuations when benchmark prices based on actual transacted price/yield are used in place of mathematically derived fair valuations.

- Greater efficiency in the price-discovery process for both issuers and investors that would also support active trading in the bond market.

- An active secondary market (particularly for lower-rated bonds) can spur purchases of such bonds in the primary market and effectively boost demand for A-rated bonds.

- Improved secondary-market liquidity conditions and the resulting availability of a credible benchmark bond index would help encourage foreign investors to take on greater exposure in the ringgit corporate bond market in supplement of their existing exposures in the ringgit sovereign bond market.

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